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IN THE

Supreme Court of the United States

OCTOBER TERM, 1974

No. ~~74~~ 701

ECONOMY FINANCE CORPORATION, TRANSFEREE OF THE ASSETS OF NATIONAL PUBLIC LIFE INSURANCE COMPANY, AND UNITED PUBLIC LIFE INSURANCE COMPANY,

Petitioners

v.

UNITED STATES OF AMERICA

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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PETITION FOR WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioners in these consolidated cases pray that a writ of certiorari issue to review the judgment of the Court of Appeals for the Seventh Circuit (Judge Stevens dissenting), reversing judgments of the District Court for the Southern District of Indiana granting income tax refunds aggregating approximately $270,000 plus interest.

OPINIONS BELOW

The opinion of the Court of Appeals (A 1, *infra*) is reported at 501 F.2d 466. The district court's findings, conclusions and judgment (A 35, *infra*) are reported unofficially at 72-2 USTC ¶9634 and 30 AFTR 2d 5446.

JURISDICTION

The judgment of the Court of Appeals was dated and entered on July 16, 1974. Rehearing was denied on September 6, 1974 (A 57, *infra*).

This Court has jurisdiction to review the judgment of the Court of Appeals by writ of certiorari under 28 U.S.C. §1254(1).

QUESTION PRESENTED

Two reinsurance companies, as required by admittedly *bona fide* reinsurance treaties with an unrelated prime insurer and by state insurance regulations, reinsured life risks (and held commensurate life reserves) for the full terms of the policies but reinsured accident and health ("A&H") risks only on a monthly "earned" basis (and, accordingly, held no A&H unearned premium reserves). Since *life* reserves were more than 50% of *total* reserves, taxpayers literally met the "reserve-ratio" test of qualification for life insurance company tax status under §801(a) of the Internal Revenue Code.

The question is whether disqualifying gross A&H unearned premiums actually held—and required to be held—by the unrelated prime insurer may be attributed to the reinsurance companies, without either statutory or decisional authority and in violation of the axiom that (absent sham or lack of business purpose) taxpayers may structure their affairs to minimize taxes, solely to achieve a tax result which comports with the Seventh Circuit's archaic view of the purpose for taxing life insurance companies differently from casualty companies.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.)

§ 801(a) *Life Insurance Company Defined.*—
For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

• • •

§ 801(b) *Life Insurance Reserves Defined.*—
(1) In General.—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

• • •

§ 801(c) *Total Reserves Defined.*—
For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

Treasury Regulations on Income Tax (26 C.F.R.)

§ 1.801-3 *Definitions*

• • •

(e) Unearned premiums. The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

STATEMENT

The Undisputed Facts

The basic facts, which are undisputed, are taken from the district court's findings of fact. (A 35-55)

The two taxpayers, National Public Life Insurance Company and United Public Life Insurance Company, reinsured credit life and credit accident and health ("A&H") insurance policies issued to customers of various finance

companies by the prime carrier, Standard Life Insurance Company.[1] (Although some of the finance companies were related in ownership to the reinsurance companies, Standard was completely unrelated.)

Under the reinsurance treaties between Standard and the reinsurance companies, the *life* policies were reinsured on an "as written" basis, i.e., the risk for the entire term of each policy and the related reinsurance premium passed immediately to the reinsurance companies, which were required by the state insurance commissions to establish appropriate life insurance reserves for the risks assumed. On the other hand, the *A&H* policies were reinsured monthly on an "earned" basis, i.e., the risk for only one month at a time and the related reinsurance premium passed to the reinsurance companies and, since the one-month premium was fully earned when received, the reinsurance companies were not required by the insurance commissions to—and did not in fact—establish any A&H insurance reserves. (Standard, which retained the A&H premiums paid in advance for future months' coverage, was required to—and did—establish unearned premium reserves.)[2]

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1 Credit insurance is advance single-premium life or A&H insurance taken out by a borrower for the term of his loan to insure its payment in case of death or disability.

2 The reinsurance treaties were subject to cancellation by the reinsurance companies, on 30 days' notice, in which case they remained fully liable on the life policies in force, but Standard remained fully liable on the A&H policies except for, as the district court found, a "limited amount" of contribution from the reinsurance companies—a maximum of 10% of the preceding year's A&H reinsurance premiums—if and to the extent losses exceeded Standard's unearned premium reserve. (A 44-45)

One reason for the reinsurance companies' reinsuring the A&H policies on a monthly earned basis was to avoid accumulating large unearned premium reserves on A&H insurance which might arguably disqualify them as life insurance companies for tax purposes under the reserve-ratio test in §801(a) of the Internal Revenue Code. (At least 50% of an insurance company's total reserves must consist of specified types of qualifying reserves—generally, life insurance reserves and unearned premium and unpaid loss reserves on *non-cancellable* A&H policies.)[3] Another reason the A&H policies were reinsured on a monthly earned basis was to avoid the danger of insolvency which would have resulted if the reinsurance companies had reinsured the A&H risks for the entire term and had been required to set up a reserve consisting of the entire *gross* unearned premiums even though they would have received the premiums *net* of agents' commissions.[4] This was no speculative danger: The district court found that United Public Life would have been insolvent by $161,000 in 1961 if it had taken the entire A&H risk. (A 50-51)

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[3] It is unclear whether single premium credit A&H policies, which are literally non-cancellable for the term for which they are written, are the kind of "non-cancellable" policies whose unearned premium reserves may qualify. Although the statute itself does not contain a definition of "non-cancellable", the Treasury takes the position that it refers only to a policy which continues—or is guaranteed renewable—to age 60 or over. Treas. Reg. §1.801-3(c). Cf. *Alinco Life Insurance Co.* v. *United States*, 373 F.2d 336, 354 (Ct. Cl. 1967).

[4] While a *life* insurance reserve consists only of the *net* premium (the actuarially computed portion of the gross premium necessary to fund the insurance risk, i.e., net of acquisition costs, expenses and profit, commonly called "loading"), *A&H* insurance reserves historically consist of the *gross* unearned premium, unreduced by loading.

The District Court Decision for Taxpayers

The district court rejected the government's attempt to attribute to the reinsurance companies non-qualifying A&H unearned premiums which they had not received and, consequently, reserves which they did not have and were not required to maintain, finding that monthly reinsurance on an earned basis is not uncommon in the insurance industry and that, while avoiding disqualification as life insurance companies was undoubtedly a motive, both Standard and the reinsurance companies "had substantial non-tax business purposes" for the arrangement. (A 51)

The Seventh Circuit's Reversal

The Seventh Circuit reversed in a 2-1 decision which not only failed to find the district court's business purpose findings to be "clearly erroneous", but indeed recognized that the reinsurance companies had a "creditable motivation for reinsuring on a month-to-month basis" and accepted "the legitimacy of that purpose". (A 9) The majority held that even though the reinsurance companies literally qualified as life insurance companies, under the statutory reserve-ratio test, Standard's unearned premium reserves "are attributable to them" and they should therefore be denied that status because the type of policies they were reinsuring lacked the "long term investment feature of life insurance companies", which the majority perceived to be the Congressional rationale of special tax treatment for life insurance companies, and treating the reinsurance companies as casualty insurance companies "more properly taxes the total business arrangement." (A 14-15, 28) The court also rejected taxpayers' alternative contentions, not passed on by the district court, that they nevertheless

qualified as life insurance companies because (1) under the Treasury's own regulations, only the *net* unearned premiums on the A&H policies should be included in calculating the reserve ratio, consistently with the use of the *net* premiums on life policies, and (2) in any event, the unearned premiums were attributable to A&H policies which were "non-cancellable" and were therefore qualifying reserves under the plain language of the statute.

Judge Stevens dissented on the ground that Congress has adopted a simple test for deciding when the life insurance portion of a company's business was sufficient to characterize it as a life insurance company and the reinsurance companies passed that test because, under the treaties, about 90% of their total reserves were life reserves. (A 29) He was concerned that the approach urged by the government and adopted by the majority was "non-statutory", based on "an attempt to effectuate the majority's understanding of the underlying rationale for special tax treatment for life insurance companies", and "would lead to the disqualification of any company writing nothing but term life insurance." (A 32-33)

REASONS FOR GRANTING THE WRIT

1. The Tax Collector's Vendetta Against Credit Insurance. This case is the latest chapter in a long history of abortive attempts by the Internal Revenue Service to restructure credit insurance transactions in order to produce maximum taxes. See Judge Fay's dissent in *Local Finance Corp.* v. *Commissioner*, 48 T.C. 773, 803 (1967), subsequently vindicated by this Court in the *First Security Bank* case, *infra*. In *Alinco Life Insurance Co.* v. *United States*, 373 F.2d 336, 340-341, 343 (Ct. Cl. 1967), the Court of Claims rebuffed an attack on the life insurance company tax status of a credit reinsurance company admittedly formed by a finance company parent with an eye to the then favorable tax provisions because the reinsurance company met the technical requirements of the statute and there was a bona fide business purpose for its formation. And in *Local Finance Corp.* v. *Commissioner*, 407 F.2d 629 (7th Cir. 1969), *cert. denied*, 396 U.S. 956 (1969), the Seventh Circuit misapplied this Court's anticipatory-assignment-of-income doctrine and the Code provision which authorizes the reallocation of income among commonly controlled businesses when necessary to avoid tax evasion or distortion, in order to reallocate a portion of a credit reinsurance company's premium income as commission income to the related finance companies whose loan business had generated the insurance premiums, but which could not receive insurance commission income under state law. The Seventh Circuit's error was corrected by this Court in *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394, 405, 406, n. 22 (1972):

"Apart from the inequity of attributing to the Banks taxable income that they have not received and may not lawfully receive, neither the statute nor our prior decisions require such a result."

2. The Seventh Circuit Has Restructured a Bona Fide Business Arrangement Solely to Maximize Taxes. Now, the government has again prevailed on the Seventh Circuit to restructure a credit insurance transaction with an acknowledged bona fide business purpose—this time under the guise of looking behind the simple and mechanical Congressional test of life insurance company tax status to achieve what the majority erroneously conceived to be the purpose of taxing life insurance companies differently from casualty insurance companies and without the benefit of any statutory provision or precedent.[5]

3. The Seventh Circuit Has Misapplied This Court's Substance-Over-Form Doctrine. The Seventh Circuit's decision conflicts sharply with one of the most fundamental of all federal tax principles, consistently articulated and applied by this and the other federal courts for 40 years, that a taxpayer is free to structure his business affairs to achieve the most favorable tax result so long as the transaction is not a sham, has a bone fide business purpose, and

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[5] At least in *Local Finance* and *First Security Bank* the government's reallocation of income between the reinsurance company and the related lending institution had the color of statutory support in §482 of the Code. Here, Standard and the reinsurance companies are completely unrelated and there is no authority for reallocating Standard's premium income or the related unearned premium reserves to the reinsurance companies other than the court's bald conclusion that treating the reinsurance companies as casualty insurance companies "more properly taxes the total business arrangement." (A 15)

has economic substance other than to reduce taxes. See *Gregory* v. *Helvering*, 293 U.S. 465, 469-470 (1935); *Knetsch* v. *United States*, 364 U.S. 361, 365-366 (1960); *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394, 398, n. 4 (1972); *Alinco Life Insurance Co.* v. *United States*, 373 F.2d 336, 340-341, 343 (Ct. Cl. 1967). The consequences of allowing a decision to stand which ignores this doctrine[6] and allows a court to restructure admittedly bona fide business transactions simply because a "literal" application of the Congressional test does not effectuate its notion of the purpose of the test (A 15, 18-19) are indeed frightening.

4. The Seventh Circuit's Archaic View of Life Insurance Taxation Jeopardizes the Status of Companies Writing Billions of Term Insurance. Moreover, as the dissent points out, the majority has completely misconceived the Congressional purpose in a way which could result in the disallowance of life insurance company tax status to any company writing predominantly term insurance. Looking to the concept underlying the original 1921 scheme of life insurance taxation, under which only investment income was taxed because underwriting income was thought

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[6] The majority disclaims reliance on the substance-over-form doctrine in attributing Standard's unearned premium reserves to the reinsurance companies, stating that the question is "rather one of the proper characterization of the substance". (A 9) This, to borrow Judge Learned Hand's famous phrase, is "mere cant". See *Commissioner* v. *First Security Bank of Utah*, 405 U.S. at 399, n. 4. Since Standard—and not the reinsurance companies—held the A&H unearned premium reserves, the only way they could be taken into account in calculating the reserve-ratios of the reinsurance companies is by some sort of reallocation or attribution for which there is no authority in federal tax law other than the substance-over-form doctrine the court says it is not applying.

to be too speculative to measure, the court says that it is the "long term investment feature of life insurance companies which mandates special tax treatment" and denies life insurance company tax status to these reinsurance companies because their A&H policies manifestly do not carry a reserve for future premium deficits, as did the classic level premium ordinary life policies being written in 1921. (A 14) But the insurance industry has changed dramatically since 1921. Today, *term* insurance predominates[7] and carries no long-term investment reserves. Congress was well aware of this change in the type of insurance being sold and revised the life insurance company taxing formula in 1959 to include a tax, in phases, on underwriting income; but Congress has not chosen to change the test of life insurance qualification. The 1921 reserve-ratio test was reviewed and somewhat liberalized in 1942 (to add unearned premiums and unpaid losses on non-cancellable A&H insurance as qualifying reserves) but has remained essentially intact until the court below saw fit to change it judicially. See the history-of-life-insurance taxation discussion in *Alinco Life Insurance Co.* v. *United States*, 373 F.2d 336, 346-349 (Ct. Cl. 1967) and S. REP. NO. 291, 86th Cong., 1st Sess., 1959 U.S.C. Cong. & Admin. News 1575, 1581 on the Life Insurance Company Income Tax Act of 1959, Act of June 25, 1959, Pub. L. No. 86-69, §2a, 73 Stat. 112 (26 U.S.C. §§801-820).

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[7] In 1970, 60% of all life insurance in force in the United States was term insurance (including credit life insurance which is *all* short term insurance). Credit life insurance, alone, accounted for $88 billion, or 6%, of all life insurance in force. *Life Insurance Fact Book*, p. 27 (Institute of Life Insurance, 1973).

5. The Attribution of Standard's Reserves to the Reinsurance Companies Violates State Insurance Regulatory Accounting Concepts. As the district court found (A 48, 51-52), the reinsurance arrangements between Standard and the reinsurance companies were not unusual and the reserves maintained by the parties were reported on their Annual Statements, as prescribed by the insurance regulatory commissions:

> "No state regulatory agency would have required [the reinsurance companies] to set up unearned premium reserves with respect to credit accident and health insurance which was issued by Standard Life and reinsured by [the reinsurance companies]."

By attributing Standard's unearned premium reserves to the reinsurance companies, ostensibly for the "limited purpose" of determining taxpayers' qualifying ratio (A 9), the Seventh Circuit has forced a tax result inconsistent with insurance regulatory accounting and with the fundamental precept that income taxation of heavily regulated industries should follow regulatory concepts, absent some overriding consideration not present here. Cf. *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394 (1972) (prohibiting the attribution of credit insurance commission income to the originating banks which did not and could not lawfully receive it); and *Commissioner* v. *Idaho Power Co.*, ... U.S. ....., 94 S.Ct. 2757 (1974). See also *Continental Insurance Co.* v. *United States*, 474 F.2d 661, 666-667 (Ct. Cl. 1973), pointing out that insurance tax terminology and concepts follow industry usage developed in response to pervasive state regulation and reflected in the Annual Statement prescribed by the National Association of Insurance Commissioners.

6. The Lower Courts Need Guidelines to Handle the Government's Continuing Efforts to Restructure Credit Insurance Transactions. While there is not yet any Court of Appeals or Court of Claims decision squarely in conflict with the Seventh Circuit's decision in this case, there are at least several cases pending which illustrate potential conflict and a need for this court to determine whether insurance reserves held—and required by contract and regulatory authorities to be held—by one insurance company may be attributed to another insurance company for purposes of the life insurance company reserve-ratio qualification test. In *Penn Security Life Insurance Co.* v. *United States* (Ct. Cl. No. 109-68, March 2, 1973), Trial Judge Fletcher refused to reallocate A&H unearned premium reserves under virtually identical facts, expressing "full agreement with the District Court's reasoning and result" in this case. That case is pending, on review, before the full Court of Claims. And in *First Railroad and Banking Co. of Georgia* v. *United States,* 73-1 USTC ¶9395, 31 AFTR 2d 1162 (S.D. Ga. 1973), pending on appeal to the Fifth Circuit, the court upheld the life insurance company tax status of a subsidiary which had ceded A&H premiums to its parent in order to avoid disqualification even though, under the reinsurance treaty, there was no real shifting of risk. Finally, in *Superior Life Insurance Co.* v. *United States,* 462 F.2d 945 (4th Cir. 1972), the district court rejected an attribution of disqualifying A&H premiums between a credit insurance company and its finance company parent, following the same reasoning as the district court in this case. The Fourth Circuit reversed, but only because it found that, under the facts and applicable state law, the finance company parent held the premiums as *agent* for the subsidiary. These cases

demonstrate that the question of insurance premium attribution in life insurance company tax qualification is an important and complex issue with which the lower courts are currently grappling and on which they need guidance.

7. The Seventh Circuit's Holding that Gross—Rather than Net—Unearned Premiums Are Includable in the Reserve-Ratio Formula Conflicts with the Treasury's Own Regulations and Two Appellate Court Decisions. As the Seventh Circuit recognized (A 10), the whole purpose of the reserve-ratio test is to measure the predominant nature of an insurance company's business in terms of its reserves. See *Alinco Life Insurance Co.* v. *United States*, 373 F.2d 336, 347 (Ct. Cl. 1967). By requiring the reinsurance companies to use Standard's *gross* A&H unearned premium reserves in the denominator of their reserve-ratio fractions, the Seventh Circuit unduly magnified their A&H reserves because *gross* unearned premiums include "loading" (expenses and profit), which is not properly part of an insurance reserve and is not included in the life reserves with which the A&H reserves are being compared. Not only does this unfairly distort the comparison of the two types of reserves; it squarely conflicts with Treas. Reg. §1.801-3(e), which defines unearned premiums as "those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance", and two decisions which have held that only the *net* premium necessary to fund the insurance risk is properly an insurance reserve. *Great Commonwealth Life Insurance Co.* v. *United States*, 491 F.2d 109, 113 (5th Cir. 1974); *Alinco Life Insurance Co.* v. *United States*, 373 F.2d 336, 353-354 (Ct. Cl. 1967).

CONCLUSION

In restructuring the tax consequences of a bona fide reinsurance treaty between unrelated parties, the Seventh Circuit has, without statutory or decisional foundation, transgressed the outer limits of the substance-over-form doctrine of *Gregory* v. *Helvering* and its progeny to reach a tax result contrary to the Congressional scheme of insurance taxation, state insurance regulatory principles, and the decisions of all other courts which have had occasion to pass on the government's latest attack on credit insurance. Certiorari should be granted so this Court can consider questions which are important to the administration of the tax laws in the insurance industry and to the resolution of litigation pending in the lower courts.

Respectfully submitted,

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In the United States Court of Appeals For the Seventh Circuit

Nos. 72-2024, 72-2025

ECONOMY FINANCE CORPORATION, Transferee of the Assets of National Public Life Insurance Company, and
UNITED PUBLIC LIFE INSURANCE COMPANY,
Plaintiffs-Appellees,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

Appeals from the United States District Court for the Southern District of Indiana.

No. IP 68-C-295
No. IP 68-C-297
CALE J. HOLDER,
Judge.

[Entered July 16, 1974]

Before STEVENS and SPRECHER, *Circuit Judges*, and CAMPBELL,* *Senior District Judge.*

SPRECHER, *Circuit Judge.* These consolidated appeals involve the qualification of National Public Life Insurance Company[1] and United Public Life Insurance Company (taxpayers) for tax treatment under 26 U.S.C. § 801 as life insurance companies.

* Senior District Judge William J. Campbell of the Northern District of Illinois is sitting by designation.

[1] Economy Finance Corporation appears as a party to this action solely as transferee of National Public Life Insurance Company. National Life was dissolved on December 23, 1960.

I

During the taxable year of 1959, National Public Life Insurance Company (National Life), a wholly owned subsidiary of Economy Finance Corporation, was engaged in reinsurance as a Delaware corporation. The stockholders of Economy Finance, an Indiana corporation engaged in consumer lending and finance, were William L. Schloss, his wife, and his children (as primary beneficiaries of various trusts). During the taxable years of 1959 and 1961, United Public Life Insurance Company (United Life) was a Delaware corporation engaged in reinsurance. Its stockholders were Schloss Brothers, a partnership, and the children of William L. Schloss (as primary beneficiaries of various trusts).

For the years in question, taxpayers filed tax returns on the assumption that they qualified as life insurance companies under 26 U.S.C. § 801(a). The commissioner determined that § 801(a) was inapplicable to them and assessed deficiencies plus interest against Economy Finance as transferee and United Life in the amount of $62,275.93 and $101,627.11 respectively. Taxpayers brought suit for a refund.

The parties settled all issues raised in the pleadings except the question of taxpayers' qualification for taxation as life insurance companies under the reserve-ratio test.

The two insurance companies were engaged in the business of reinsuring credit life and credit health and accident (H & A) insurance policies; they did no other business. The insurance contracts reinsured by National Life in 1959 were issued to insure the lives and health of debtors of Indianapolis Morris Plan Corporation, related in its ownership to National Life, and debtors of other finance companies unrelated to National Life. The insurance contracts reinsured by United Life in 1959 were issued to insure the lives and health of debtors of Economy Finance and its subsidiaries, related in their ownership to United Life, and, in 1961, to insure the debtors of Economy Finance and its subsidiaries, Indianapolis Morris Plan Corporation, and other finance companies unrelated to United Life.

These finance companies typically made three-year consumer credit loans, which were paid off in an average of twenty-one months. At the time such loans were made, the companies suggested that the debtor take out life or life and H & A credit insurance policies so that

(a) in case of death or dismemberment of the debtor, the total outstanding balance of the loan would be repaid upon proof of claim;

(b) in case of sickness or injury of the debtor such that he or she was disabled for a minimum 14-day period, the stream of payments would be met as each fell due during the period of disability.

The term of the insurance would cover the term of the loan. If the debtor agreed to purchase such insurance, an amount equal to the total cost of carrying insurance for the term of the loan was added to the principal of the loan and then deducted from the amount given to the debtor.

Rather than insuring the credit life and H & A insurance directly, the taxpayers entered into an arrangement with Standard Life Insurance Company (Standard), a corporation independent of the Schloss holdings, which issued each policy purchased. The finance companies forwarded the premium (less agent's commission) along with the insurance application to the Schloss Insurance Agency (SIA), an Indiana general partnership owned by the Schloss family. SIA issued an insurance contract underwritten by Standard and acted as Standard's general agent for issuing and administering the policies. After deducting an agent's commission, SIA forwarded the balance of the premium received to Standard.

Pursuant to the agreement, Standard reinsured each credit life and H & A policy under reinsurance treaties entered into between Standard and National Life and between Standard and United Life.[2]

[2] Plaintiffs' expert witness, Arthur Crooks Eddy, an actuary, testified that there are two basic types of reinsurance arrangements. Risk premium reinsurance is an arrangement where only the mortality or morbidity risk is reinsured. The ceding company retains a portion of the premium to cover its liability for expenses and the reinsurer receives the balance for the mortality or morbidity element to cover

The *life* reinsurance treaties (identical for each taxpayer) provided for Standard to cede to taxpayer 100 percent of each credit life insurance policy issued by Standard with respect to the debtors of the finance companies. The treaties contained the following provisions:

(1) Standard agreed to pay taxpayer a monthly reinsurance premium on each life insurance policy reinsured equal to 98.3 percent of the gross monthly *paid* premiums for the preceding month, less commissions paid to agents.

(2) "Gross monthly paid premiums" were defined as the *full* premiums on all policies issued, less premiums refunded on any canceled credit life insurance policy.

(3) At the time the reinsurance premium was paid to taxpayer, Standard was to submit a bill to taxpayer for all losses paid by it during the preceding month and for its direct demonstrable expenses, including taxes, claim expense, and printing, paid in the preceding month.

(4) Cancellation of the treaty agreement by taxpayer upon thirty days' notice would not affect any policies written and reinsured prior to the effective date of cancellation of the treaty.

The *health and accident* reinsurance treaties (identical for each taxpayer) provided for Standard to cede to taxpayer 100 percent of each credit H & A policy issued by Standard with respect to the debtors of the finance companies. The treaties contained the following provisions:

(1) Standard agreed to pay taxpayer a reinsurance premium equal to 98.3 percent of the gross monthly *earned* premiums thereon, less commissions paid to agents and less Standard's direct demonstrable expenses.

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[2] (Continued)

its liability for claims. Coinsurance is an arrangement whereby a larger company offers to take the place of a smaller issuing company in the first policy year or so of some percentage of the issuing company's business. The reinsurer receives the entire premium and is responsible for the surplus drain in the first year of the policy (commissions plus underwriting expense generally exceed the premium in the first year). Mr. Eddy testified that the reinsurance agreement in this case is a hybrid of the classic categories.

(2) "Gross monthly earned premiums" were defined as "the pro rata part of the single premium corresponding to the duration of insurance coverage provided for in said policy during the preceding month."

(3) At the time the reinsurance premium was paid to taxpayer, Standard was to submit a bill for all losses paid by it during the preceding month.

(4) Each treaty provided, "It is understood that NATIONAL [or UNITED] is reinsuring said risks for a period of one month only; provided, however, that this agreement shall automatically renew itself from month to month until such time as the individual policies covered by this treaty run out, lapse, are canceled or in any way terminate; or until this treaty is canceled as provided in ARTICLE IX, NATIONAL [or UNITED] shall have no right, title or interest in any unearned premiums or unearned premium reserves held by STANDARD."

Cancellation of the Treaty Agreement by taxpayer upon 30 days' notice limited their liability as follows:

> STANDARD shall pay to NATIONAL [or UNITED] within 30 days after date of such cancellation the total of all earned portions of single premiums as of the date of such cancellations, for such policies less an unpaid claim reserve. Such unpaid claim reserve shall be an amount estimated by STANDARD to be sufficient to pay all claims and expenses reimbursable hereunder for losses incurred or unreported and unpaid at the date of such cancellation. On the date six months after such cancellation an accounting shall be made of such claims paid and STANDARD shall thereupon pay to NATIONAL [or UNITED] any excess of the aforesaid claim reserve over such claims actually paid, together with expenses reimbursable hereunder, conversely, NATIONAL [or UNITED] shall pay to STANDARD any excess paid by it for such claims and expenses incident thereto over and above the aforesaid claim whereupon all liability of the parties each to the other shall cease and determine.

Article IX further provided that:

> If NATIONAL [or UNITED] cancels this treaty as provided for [herein], and should the claims and expenses subsequently incurred and paid in connection with all business covered under this treaty then in force carried by STANDARD, plus one and seven-tenths per cent (1 7/10%) of unearned gross premiums on such date of cancellation, exceed the unearned net premiums held by STANDARD on the date of cancellation, then NATIONAL [or UNITED] will, thirty (30) days after the expiry of all such insurance contribute to STANDARD a sum that would be necessary to reimburse STANDARD for the following items only to the extent that the total of such items exceed the unearned net premiums held by STANDARD on the date of said cancellation, but in no case more than 10% of the total premiums earned by NATIONAL [or UNITED] during the twelve (12) months immediately preceding the date of cancellation of this Contract:
>
> 1. One and seven-tenths percent (1 7/10%) of such gross unearned premiums.
> 2. STANDARD's direct demonstrable expenses incurred after such effective date of cancellation.
> 3. Losses paid and incurred on all insurance written under this treaty not recovered through reinsurance with NATIONAL [or UNITED].
>
> The additional amount to be so retained by STANDARD, if any, shall be refunded to STANDARD by NATIONAL [or UNITED] on demand, any time before one (1) year after the expiration of the last of said policies.
>
> STANDARD shall have the right to retain all premiums unearned at the date of cancellation.

II

With respect to the agreement to reinsure the H & A policies on an "earned" basis, at trial the parties stipulated as follows:

National Life and United Life reinsured credit accident and health insurance on a month-to-month basis, rather than for the full term of the policies, in order to avoid holding any unearned accident and health premium reserves and, therefore, reduce the amount of reserves which might be considered as nonqualifying reserves for the purpose of determining whether they were entitled to be taxed as life insurance companies under the reserve-ratio formula in § 801(a) of the Code.

Standard reported the H & A reinsurance premiums not yet due as an unearned premium reserve on its annual statement to the California Insurance Department. Out of the unearned premium reserve set up by Standard, a balance roughly equivalent to one month's life plus H & A claims was kept in a bank checking account. The balance of the reserve fund was invested from time to time in Economy Finance Corporation debentures.[3] The interest from these debentures was remitted to SIA as an additional commission. "Taxpayers" did not report any portion of the reinsurance premiums not yet due on their annual statements to the Delaware insurance authorities.

For the taxable years in question, taxpayers reported under 26 U.S.C. § 801(b)(5) the following mean reserves on their tax returns, which resulted in the following percentage qualifying ratio under 26 U.S.C. § 801(a):

Taxpayer	Taxable Year	Life Insurance Reserves (Numerator)	Total Reserves (Denominator)	Percentage Qualifying Ratio
National Life	1959	$184,928.50	$204,334.37	90.50%
United Life	1959	23,497.00	26,561.79	88.46%
United Life	1961	322,055.00	336,215.63	95.79%

[3] Plaintiffs' Exhibit 14 indicates the following disposition of the reserves as of December 31 of each year listed.

	Unearned accident and health premiums reserve	Amount of those reserves on loan to Economy Finance	Remaining amount in bank account
1958	$369,424.84	$313,000.00	$56,424.84
1959	356,080.05	293,000.00	63,701.52
1960	379,549.99	313,000.00	67,171.48
1961	292,872.29	233,000.00	60,039.05

The Internal Revenue Service determined upon audit that, for purposes of the reserve-ratio qualifying formula of § 801(a), taxpayers must include the nonqualifying H & A unearned premium reserve held by Standard in their total insurance reserves. This decision was based on the premise that the reserve-ratio test was intended to reflect the primary insurance risks assumed by taxpayers, and to grant life insurance taxation treatment only to taxpayers primarily insuring life insurance risks. Excluding reserves maintained with respect to the H & A policies from taxpayers' total insurance reserves distorted the composition of the risks actually assumed. Accordingly, the I.R.S. adjusted taxpayers' total reserves by an amount equal to the arithmetic mean as of the beginning and end of each year, of the gross monthly unearned credit H & A insurance premiums (less commission and refunds on cancellations) which had been received by Standard but which were not yet due to be paid to taxpayers:

Taxpayer	Taxable Year	Reported Total Reserves	Total Reserves as Adjusted by the Service	Reserve Ratio as Determined by the Service
National Life	1959	$204,334.37	$510,061.22	36%
United Life	1959	26,561.79	83,587.39	28%
United Life	1961	336,215.63	672,426.77	48%

On the basis of this adjustment, taxpayers were not qualified for taxation as life insurance companies.

The district court found both taxpayers qualified for taxation under the reserve-ratio test as life insurance companies for the reason that the attribution of the H & A premiums to taxpayers did not comport with the economics of the reinsurance agreement. He found Standard was the proper party to set up an unearned premium reserve in accordance with insurance accounting practices, and that there are substantial non-tax business reasons for entering into a reinsurance arrangement.

The district court found that, since both taxpayers were unable directly to underwrite H & A insurance in the states involved (because of inadequate capitalization

and surplus), they had to engage in a reinsurance arrangement. The reinsurance for H & A policies was on a monthly earned basis because of the surplus drain resulting from having to reserve on the basis of gross unearned premiums. Standard enhanced its liquidity position[4] and minimized its risk[5] by reinsuring on a monthly basis.

Because the parties narrowed the issue to the proper treatment of the H & A reinsurance premiums, the only relevant non-tax purpose cited by the district court is one compelling reinsurance on an earned basis, not reinsurance per se. We agree that avoiding surplus drain was a creditable motivation for reinsuring on a month-to-month basis in the instant case. As a result, taxpayers could not establish an unearned premium reserve, because the premiums were not received until they were fully earned. However, accepting the legitimacy of that purpose does not end the inquiry. The issue raised by the government is not whether taxpayers should actually have established H & A reserves but how such reserves should be considered for the limited purpose of determining taxpayers' qualifying ratio. This is not a question of form over substance but rather one of the proper characterization of the substance.

III

A. *Insurance Reserves*

Insurance contract premiums are composed of a loading factor and the valuation premium. The loading factor is intended to cover:

> "(a) both the specific expense anticipated in providing the respective coverage and an equitable

[4] This finding is somewhat puzzling since the asset was offset by the liability to taxpayers. Additionally, Standard had to invest a substantial amount of the fund in Economy debentures and did not receive the interest thereon. This finding could only refer to the payment of claims and expenses in advance of taxpayers' remittances or to an "appearance" of greater liquidity.

[5] The district court found that by reinsuring on a monthly basis Standard "thereby substituted a claim against Economy Finance for claims which it otherwise would have had against substantially smaller companies . . . ." It would seem that retaining the unearned premium portion would secure all the insulation possible from taxpayers' instability. We fail to see how investing in Economy Finance debentures adds anything. The substitution of claims was the result of the agreement exacted by taxpayers, not a reason for the arrangement.

> portion of the general expense incurred by the insurer and (b), a margin for an equitable share in any loss of an unpredictable nature which may be experienced by the company in the conduct of its business. The amount of such loading is ordinarily arrived at by arbitrary methods which reflect the judgment of the actuary making the computation."[6]

The valuation premium's purpose varies with the type of insurance coverage. In the case of whole life or endowment policies, the valuation premium is

> "(1) to cover the individual policyholder's share of the current year's death claims, and (2) to provide for the accumulation of the funds required for the payment of the face amount of the policy at its ultimate maturity other than by death."

WIGHTMAN at 262. Under a term life insurance policy, such as those involved in this case, item (1) above applies but item (2) is not necessary inasmuch as the policy can only mature in the event of death. For health and accident policies, the valuation premium is intended to cover the policyholder's share of the current year's health and accident claims.[7]

Since life insurance companies are defined under the tax code in terms of the reserves they hold, a proper understanding of the nature of insurance reserves is necessary to an understanding of the true basis of income and the objectives of the tax scheme. In insurance accounting, the "reserve" entry is substantially different from

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[6] E. C. WIGHTMAN, LIFE INSURANCE STATEMENTS AND ACCOUNTS 261 (1952) [hereinafter cited as WIGHTMAN].

[7] For life or health and accident policies the valuation premium is computed by reference respectively to a mortality or morbidity table that reflects the appropriate risk attendant to the contract.

> "In the computation of an annual valuation premium, two preliminary calculations are required, namely: (1) the determination of the present value of the promised benefit; and (2) the computation of the present value of the annual payment of a unit sum (U.S. dollar) for the specified premium-paying period or the life-time of the insured, whichever is the lesser [in the case of life insurance. For health and accident policies, for the specified premium-paying period.] The actual valuation premium is then found by dividing the amount of the present value of the benefit (1) by the present value of the unit payments (2)."

WIGHTMAN at 261-62.

conventional accounting reserves; and the two reserves herein involved, the unearned premium reserve and the policy reserve, are substantially different from each other. The method of computing reserves is regulated by the states as a part of their effort to enforce solvency requirements. Reserves are maintained according to such state regulations.

In the simplest sense, reserves are accounting entries which reflect

> . . . actual and potential liabilities under outstanding insurance contracts. Since insurance premiums are collected in advance and losses paid out over a period of time, an insurer, assuming premiums were initially adequate, will always have in its possession assets which are "earmarked" for the payment of claims in the future. It would be unsound from an actuarial as well as an accounting viewpoint to look upon these assets as the property of the company or its owners.[8]

For health and accident policies, insurance reserves are of two types, premium reserves and loss reserves. The unearned premium reserve maintained by Standard is a type of premium reserve which is

> . . . set up to reflect the liability of the company for losses which have not yet occurred but for which premiums have been paid. Essentially, they represent premiums which have been received but are as yet unearned; that is, the promised protection has not yet been granted.

DICKERSON at 384.[9] The H & A policies issued by Standard covered an average of twenty-one months, but the entire premium was paid in advance. To reflect this future liability, which was to be discharged through reinsuring the business with taxpayers, Standard maintained an

[8] O. D. DICKERSON, HEALTH INSURANCE 383 (1959) [hereinafter cited as DICKERSON].

[9] "Loss reserves, on the other hand, represent the liability of the company for events which have already taken place but for which settlement is not yet complete. This includes losses where notice has not yet been received, cases in process of investigation, settlement, or litigation, and cases where liability is admitted but benefits are payable over a period of time." *Id.* at 384.

unearned premium reserve account. If taxpayers had reinsured the entire period of coverage at the outset rather than on a month-to-month basis, they would have been required to set up the unearned premium reserve to reflect their liability to grant protection in the future (*i.e.*, payment of future loss claims). By reinsuring H & A risks on a month-to-month basis, once taxpayers received the reinsurance premiums from Standard they were fully earned in the sense that the protection had been granted.[10]

Most states require that the unearned premium reserve equal the gross unearned premium; in other words, that it "equal all premiums received which apply to periods beyond the valuation date." DICKERSON at 385; see n. 31, *infra*. Standard maintained its unearned premium reserve on a monthly pro rata basis and remitted the reinsurance premiums on the same basis.

For whole life and endowment insurance policies, the premium reserve is based on the valuation premium as opposed to the entire contract premium used in the calculation of the unearned premium reserve. The premium reserve, entitled the policy reserve, comprises both a premium equalization fund and a sinking fund. The premium equalization fund consists of that portion of the valuation premium designed to equalize mortality costs over the period of the policy to account for the premium amount remaining constant while the mortality risk increases at an accelerating rate. The sinking fund consists of that portion of the valuation premium calculated to provide for payment of the face amount of the policy at maturity other than by death. WIGHTMAN at 567-68. The policy reserve demonstrates the dual nature of life insurance, serving both an insurance and a banking function. The equalization fund provides for the cost of the insurance benefit rendered each policy year and the sinking fund is fundamentally a savings account.

> The actual operation would be the same if the insured were to deposit each year in a savings bank (which

[10] At that point, they were only required to set up loss reserves. Taxpayers each maintained two reserves with respect to the H & A policies—one to reflect the present value of amounts not yet due on claims (for approved claims where the date of payment is in the future) and the other to reflect claims that had been incurred but not yet reported.

> allowed the same rate of interest on deposits with it as the valuation rate provided in the corresponding insurance policy) the same varying portion of the premium which is required for the terminal reserve under the corresponding endowment or life policy for the respective year and were to purchase a policy from an insurance company running for the corresponding term of years wherein the amount of insurance thereunder in any year would be the difference between the face amount of the corresponding endowment or life policy and the accumulated deposits in the savings bank at the end of the respective policy year.

WIGHTMAN at 572. *See also Penn Mutual Life Ins. Co. v. Lederer*, 252 U.S. 523, 531-34 (1919).

For term life insurance the policy reserve consists only of a premium equalization fund.

> In this case, the policy reserve is, in effect, a deferred credit to the insurer's income, differing in its fundamental character from the unearned premium reserve . . . only by reason of the fact that interest at a pre-determined rate is allowed [in the calculation of the reserve amount] on the accumulation of the temporarily unearned portion of the premiums paid.

WIGHTMAN at 567. For the single advance-premium term insurance policies involved here, the reserve consists of both an unearned premium account for the current year and an accumulation fund designed to realize the present value of death benefit costs from the discounted advance payment.

B. *Insurance Income*

There are two possible sources of income for life insurance companies, from underwriting and from investment. Underwriting income is derived from the excess of gross premiums over expenses and mortality experience. Investment income is derived from the opportunity to invest the long term policy reserve. When the gross premium is calculated, the interest factor at which the policy reserve is required by the regulatory authority

to be maintained is employed. This factor is less than normal investments generally return. The company looks at this differential as a source of income.

For insurance companies other than life, no such long term reserve is required, because the probability of the occurrence of the event insured against remains constant over time; no residual benefit (*e.g.*, death benefit, annuity) is contracted for. Once the promised protection has been granted, the premium is fully earned.[11] Thus, when the gross premium is calculated, the short term opportunity to invest unearned premium reserves is not considered significant. Consequently, underwriting income is the primary source of income. *See* 8 MERTENS, LAW OF FEDERAL INCOME TAXATION § 44.17 (1970).

It is this long term investment feature of life insurance companies which mandates special tax treatment. Until the life contract has been completely performed, it is not possible to ascertain the amount of income currently earned. For all other insurance contracts, where the event insured against may never occur and the risk of occurrence is relatively constant, the income derived from each policy period is currently capable of ascertainment. Thus in the instant case, the income taxpayers derived from H & A reinsurance is subject to different tax considerations than that derived from life reinsurance. The problem arises because Congress chose not to tax the earnings from each type of insurance business separately.

> Some companies mix with their life business accident and health insurance. It is not practicable for all companies to disassociate those businesses so that we have assumed that if this accident and health business was more than 50 percent of their business, as measured by their reserves, it could not be treated as a life insurance company. On the other hand, if their accident and health insurance were incidental and represented less than 50 percent of their business we treated them as a life insurance company.[12]

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[11] *Group Life & Health Ins. Co. v. United States*, 434 F.2d 115 (5th Cir. 1970), *cert. denied*, 402 U.S. 944 (1971).

[12] *Senate Hearings Before the Committee on Finance on Internal Revenue*, 67th Cong., 1st Sess. 85 (1921).

The issue presented by this appeal thus becomes a question of which scheme more properly taxes the total business arrangement.

IV

A life insurance company is defined in terms of a reserve-ratio qualification test. Section 801(a) provides:

> Life Insurance Company Defined.—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or non-cancellable contracts of health and accident insurance if—
>
> (1) its life insurance reserves (as defined in subsection (b))[13], plus
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,
>
> comprises more than 50 percent of its total reserves (as defined in subsection (c)).[14]

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[13] Section 801(b) defines life insurance reserves in pertinent part as follows:

> (1) In general.—For purposes of this part, the term "life insurance reserves" means amounts—
>
> (A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and
>
> (B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

[14] Section 801(c) defines "total reserves" as:

> (1) life insurance reserves,
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and
>
> (3) all other insurance reserves required by law.

The qualifying fraction can be expressed in simplified terms as follows:

Qualifying reserves (numerator)	*Total reserves (denominator)*
1. Tabular reserves on life, annuity, and noncancellable accident and health policies	1. Tabular reserves on life, annuity, and noncancellable accident and health policies
2. Unearned premiums on non-cancellable life, health, or accident policies not included in (1)	2. Unearned premiums not included in (1)
3. Unpaid losses on noncancellable life, health, or accident policies not included in (1).	3. Unpaid losses not included in (1)
	4. All other insurance reserves required by law.

Alinco Life Ins. Co. v. *United States,* 373 F.2d 336, 350 (Ct. Cl. 1967).

Section 802(b) defines life insurance company taxable income as:

The lesser of: (1) taxable investment income[15] or (2) the gain from operations[16]
+ 50% of the excess of gain from operations
+ the amount subtracted from policyholders surplus

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[15] Section 804 defines taxable investment income essentially as that portion of the return on investments which is not applied to the company's insurance reserves ("the policyholder's share of any item shall be that percentage obtained by dividing the policy and other contract liability by investment yield"). See *United States* v. *Atlas Ins. Co.*, 381 U.S. 233, 239 (1965).

[16] Section 809 defines gain from operations to include both the company's share of investment yield and underwriting income. See *Jefferson Standard Life Ins. Co.* v. *United States*, 408 F.2d 842, 845 (4th Cir. 1969).

= Life Insurance Company Taxable Income (subject to tax at the normal corporate tax and surtax rate, 26 U.S.C. § 802(a)(1))[17]

It can be seen that when gain from operations exceeds taxable investment income, underwriting income basically constitutes the excess.[18] The taxed 50 percent of gain from operations is added to the shareholders surplus account, 26 U.S.C. § 815(d). The untaxed 50 percent of gain from operations is added to the policyholders surplus account (26 U.S.C. § 815(c)),[19] which amounts are taxed only if and when they are distributed to shareholders. 26 U.S.C. § 815(a), (d) (1). As the government has noted, "[T]he immediate deferral of 50 percent of the underwriting income and the deduction amounts and the corresponding taxation of those amounts only when and if the company takes appropriate actions represents perhaps the major benefit (on an overall industry basis) flowing from qualification as a life insurance company."

Although taxpayers did not take advantage of the 50 percent deferral of gains from operations in the years in

[17] The taxpayers reported the following amounts on their tax returns pursuant to 26 U.S.C. §802(b):

	National Life	United Life	
	1959	1959	1961
1. (a) Taxable investment income	4,685.66	1,853.62	19,385.88
(b) Gain from operations	348,579.59	106,080.98	16,808.92
(c) Smaller of (a) and (b)	4,685.66	1,853.62	16,808.92
2. 50% of excess of 1(b) over 1(a)	171,946.96	52,113.68	-0-
3. Amount subtracted from policyholders' surplus account	182,554.67	49,019.42	-0-
4. Life insurance company taxable income (total of lines 1(c), 2, and 3)	359,187.29	102,986.72	16,808.92

[18] "The amount remaining is here referred to as underwriting gain since it in large part consists of mortality and loading savings . . . . In addition, however, what is here called underwriting income may also include minor amounts of investment income, since under phase 2 the life insurance company's share of the investment yield taken into account is determined on the basis of the company's own assumptions as to the interest required to be added to reserves rather than on the basis of the interest which would be added to reserves if based upon the 5-year average of the company's earning rate." S. Rep. No. 291, 86th Cong., 1st Sess. 20-21.

[19] In the determination of gain from operations, certain deductions are allowed under 26 U.S.C. § 809(d). The deductions pertaining to nonparticipating contracts (§ 809(d)(5)) and H & A insurance and group life insurance (§ 809(d)(6)) are also added to the policyholders surplus account. 26 U.S.C. § 815(c)(2) (B) and (C).

question,[20] this potential offers a substantial tax benefit. Deferral is allowed because of the inability of the life insurance business accurately to determine current income and the only reason H & A underwriting income is accorded such deferral is that it is earned in conjunction with primarily life insurance business. The deferral is allowed as a matter of convenience only.

Taxpayers' reserve ratio would lead one to the conclusion that they were almost exclusively in the life insurance business. Nevertheless, taxpayers also conducted a substantial H & A reinsurance business during the taxable year. Thus, a literal interpretation of § 801(a) requirements in this instance fails to effectuate the objective of the prescribed test, namely, the identification of the business conducted. Therefore, the H & A portion of taxpayers' business must be scrutinized in order to determine the source and significance of the resulting distortion when the reserve qualification formula is literally applied.

By defining life insurance companies in terms of the reserves they hold, Congress identified the fund which represents *inter alia* nonexcess risk. Ignoring for our purpose the fact that H & A reserves also include loading, Congress compared the actuarial estimate of the amount necessary to cover life contract obligations with the amount necessary to cover H & A obligations. By identifying the holder of nonexcess risk, it would also identify the holder of excess risk and presumably there is a correspondence between the stated amount of nonexcess and excess risk exposure. Hence the larger the amount of nonexcess risk, the larger the excess risk exposure. For life insurance it is the existence of excess risk not currently ascertainable which mandates the deferral of 50 percent of gains from operation.

The reason that the reserve-ratio test literally applied to the present insurance arrangement has failed to re-

[20] In 1959, National Life distributed all and United Life distributed most of the policyholders' surplus presumably to take advantage of a transitional tax reduction then allowed under 26 U.S.C. § 802(a)(3). In 1961, the net earned premiums as included in gain from operations were fully included in United Life's taxable income because an underwriting loss (when coupled with special life insurance company deductions, 26 U.S.C. § 809(d)) was suffered.

flect the H & A reinsurance business is because this is not a true reinsurance situation but, as taxpayers' expert testified, a hybrid. Reinsurance is undertaken to spread the risk such as in the risk premium reinsurance arrangement or to offset surplus drain as for example in coinsurance arrangements. In either case, reinsurance includes the assumption by the reinsurer of the attendant nonexcess and excess risks. Here, the taxpayers admittedly sought surplus aid but they also desired to function as the insurer on these H & A policies, business which other related taxpayers generated. As a result, the reinsurance treaties served an interim loan function but did not serve to spread the insurance risk.

The H & A reserves in Standard's hands were employed in precisely the same manner as they would have been in taxpayers' possession—for servicing expenses, claims settlement, and other related expenses.[21] Standard did not even retain the right to the return on the investment of these reserves during the period of retention. The testimony established that Standard's interest was in the commissions it received which were not affected by the claims experience, that is, the insurance risk.[22] Standard's economic interest was in the continuance of the commission income, not in the unearned premium reserves. Plaintiffs' witness, Mr. Harry V. Wade, Standard's chief executive officer, testified that Standard's only exposure to risk was in the event of taxpayer's insolvency.[23] The commission income should be considered as consideration for surplus aid, policy servicing, and exposure to the insolvency risk. Other than the insolvency risk which is not a risk considered in the reserve-ratio test, Standard performed a banking and clearing-house function and not an insurance function. We think taxpayers would agree with our analysis if the treaty did not contain a right to cancellation of the H & A treaty. The cancellation provisions do not affect our determination that for tax purposes the reserves measure taxpayers'

[21] *Cf. Superior Life Ins. Co. v. United States*, 462 F.2d 945 (4th Cir. 1972).

[22] Plaintiffs' witness, Mr. Wade, testified that Standard's interest in claims allowance related only to taxpayers' solvency, not Standard's profitability. Tr. 161-62.

[23] Primary insurers will always bear an insolvency risk in the case of insurance ceded. Nevertheless, the primary insurer is not considered on the risk for reserve requirement purposes.

business because even in the event of cancellation Standard was not exposed to excess risk.[24] It is exalting form over substance to state that in the event of cancellation Standard would be the insurer on the H & A policies because they were exposed to nonexcess risk alone. Standard would use the premiums paid by policyholders (no interest was assumed on the calculation of the reserve) to pay claims and expenses and the 1.7 percent commission; Standard would receive any morbidity or loading savings above those amounts; and, if the unearned premium reserve was insufficient, Standard had recourse against taxpayers up to 10 percent of the total premiums earned during the preceding year. To treat Standard as the insurer where there are no economically realistic downside risks in the event of cancellation confounds our understanding of the insurance business.

As an alternative ground for attributing the H & A reserve to taxpayers, the government argues that the cancellation provisions should have no tax consequences because there is no realistic likelihood of cancellation. We agree that these provisions lack economic substance for tax purposes considering the income and loan benefit to various other Sehloss enterprises, the declining balance of the H & A reserves,[25] and the fact that upon cancellation taxpayers would be in the anomalous position of having no right to any profit but would be liable to the extent of 10 percent of the total premiums earned during the preceding year in the event of excessive losses. We do not believe, as the dissent suggests, that our con-

[24] Although it would appear that taxpayers' exposure to excess risk was limited, we think this "limitation" was liberal enough virtually to insure full reimbursement to Standard in the unlikely event of cancellation. Taxpayers' expert testified that loss experience was about 30 percent of each dollar premium; further, the premiums were reserved on a pro rata rather than a declining balance basis. Hence it would be unlikely that losses would exceed this limitation. If the parties actually intended the reinsurance to be on a strict month-to-month basis, we can perceive no reason for taxpayers to expose themselves to excess risk on insurance they had not assumed. The fact that they did gives rise to the inference that they intended the risks to shift and the 10 percent figure was considered adequate to do so.

[25] Although the reserves were maintained and remitted on a pro rata basis, the risk element is constantly declining, resulting in a correspondingly increasing amount of loading in each earned premium on policies in force. Taxpayers argue that this consideration is insubstantial because the earned premiums were net commissions, the principal loading element. This contention is tantamount to stating that the profit element they accepted was not excessive. Regardless of its sufficiency, taxpayers' profit element increased over the term of each H & A contract.

clusion equates the right to cancel "with a legal obligation not to do so." To determine that a feature of a transaction has no tax significance is not tantamount to a determination that taxpayers cannot do something, only that they will not. The distribution of risks in the event of cancellation merely shows that the parties did not intend the provision to have nontax significance except insofar as they allowed Standard to hold the reserves in order to minimize its risk with respect to the surplus aid. The fact that the state insurance authorities required or permitted Standard to hold the reserve for solvency purposes does not answer the question of whose business the reserves measure. Nor is it necessary to disturb the business arrangement between the parties in order to hold that the H & A reserves measure taxpayers' business for purposes of the qualification test.

Taxpayers rely on *Penn Security Life Ins. Co.* v. *United States,* No. 109-68 (Ct. Cl., March 2, 1973), and *First Railroad & Banking Co.* v. *United States,* Civil No. 1738 (S.D. Ga., April 9, 1973), unofficially reported at 31 AFTR 2d ¶73-509, at 73-1162. In *Penn Security* the court was presented with a credit reinsurance arrangement essentially identical to the present case. Relying on the district court decision in this action, it held for the taxpayer-plaintiff. Obviously such circular reliance is of no support to taxpayers since we have rejected the district court's reasoning.

In *First Railroad,* the I.R.S. sought to include a wholly owned subsidiary in the consolidated return of the parent for the reason that the wholly owned subsidiary, which conducted a credit life and H & A insurance business, did not qualify as a life insurance company. The disallowance of § 801(a) treatment was due to a reinsurance arrangement whereby the subsidiary ceded to its parent 60 percent (later 70 percent) of the total premiums on all H & A insurance policies. This practice reduced the proportion of H & A reserves held by the subsidiary. The treaty provided for a quota share assumption of the liability, but the commission arrangement resulted in only a remote possibility of the parent's actual risk of loss.

> In order for it [the parent] to sustain permanent out of pocket losses on liability under the subject policies, there would have to be valid claims exceed-

> ing 96% of the reinsurer's earned premium, and additionally, [the subsidiary] . . . would have to be insolvent so as to preclude recapture of those losses in subsequent accounting periods.

31 AFTR 2d at 73-1164. The court found that despite the "transfer of minimal risk . . . there were substantial non-tax purposes for entering into the arrangement" and that "[t]he advantages accruing to [the subsidiary] . . . would have been the same regardless of the reinsurer." 31 AFTR 2d at 73-1164-65.

Not all the nontax purposes cited in *First Railroad* are involved in this case; those common to both cases we do not clothe with the same significance as that court did.

As stated above, in true reinsurance situations, surplus aid includes the assumption by the reinsurer of the attendant insurance risk including the risk of excessive losses. In *First Railroad*, the subsidiary through reinsurance commission adjustments effectively remained on the risk. It merely received "surplus loans" at the time the reserves were set up and in the event of excessive losses. The subsidiary paid for these loans at an "interest rate" of 4 percent of earned premiums; the parent always received any outstanding amounts of "principal" through the adjustment of the subsidiary's "commission." In the instant case, the H & A reinsurance likewise did not serve to spread insurance risks; the surplus aid served an interim loan function. *See* KIMBALL & DENENBERG, INSURANCE, GOVERNMENT AND SOCIAL POLICY 187 (1969).

The fact that reinsurance provides additional protection for policyholders does not relate to the question of whose business the reserves actually measure. This feature only serves to emphasize the fact that, with reinsurance of the type involved in *First Railroad* and in taxpayers' business, more than one company may eventually be exposed to some risk. But only one company can and must maintain the reserves related to the premiums in their possession. For example, in the present case Standard would have been liable on the credit life insurance policies in the event of taxpayers' insolvency; nevertheless, it would be inappropriate to suggest that taxpayers cannot hold the life insurance reserves by reason

of this insolvency possibility. Because the H & A treaties granted only an illusory right to escape future liability through cancellation, Standard's only risk of exposure to any insurance risk was via its insolvency risk, the same exposure posture it held with respect to the life insurance policies. The definition of reserves for tax purposes simply does not encompass an insolvency risk.

Finally, Standard did not receive any investment income as did the parent in *First Railroad*.

Insofar as *First Railroad* supports the proposition that nontax purposes for entering into a reinsurance arrangement are sufficient to avoid further analysis in terms of the objectives of § 801(a), we decline to follow it.

From the foregoing economic arrangement, we conclude that for purposes of qualification as a life insurance company, the unearned premium reserves are attributable to taxpayers.[26]

V

Having found the H & A reserve attributable to taxpayers for tax purposes, it is necessary to pass on two alternative contentions not reached by the district court.

A. *Cancellability of H & A Insurance*

Taxpayers argue that the H & A coverage is "noncancellable" as that term is used in § 801(a). The significance of this argument is that, for purposes of the reserve ratio test, unearned premium reserves on noncancellable H & A coverage are includible in both the numerator and the denominator of the reserve fraction, whereas all other H & A coverage is includible only in the numerator.

Where an insurer is contractually bound to a long term noncancellable or guaranteed renewable H & A

[26] *Cf. Commissioner* v. *Hansen*, 360 U.S. 446 (1959). The precise manner in which unearned premiums are held is not controlling, because unearned premium reserves includible in the qualification ratio need not be required by law. Treas. Reg. § 1.801-3(e). Standard's retention of the H & A unearned premium reserves will not result in double taxation of the transactions relevant to the H & A business. Standard will be required to take into income only the commission income and taxpayers will be liable for the underwriting income proper.

policy in exchange for a level annual premium, it faces an investment requirement similar to life insurance coverage. While over a short term the health of the policyholder is relatively constant, over a long term the insurance risk increases. Consequently, the company must set up a reserve in addition to the unearned premium reserve, that is, an equalization fund. *See Massachusetts Protective Ass'n* v. *United States,* 114 F.2d 304, 309 (1st Cir. 1940). In 1942, Congress provided that, in determining whether an insurer should be taxed as a life insurance company, noncancellable H & A contracts should be considered to be a part of the insurer's business which was in the nature of life insurance. Revenue Act of 1942, ch. 619, § 163, 56 Stat. 798. The type of noncancellable policy in contemplation and the reserves attendant thereto were set out by the Senate Finance Committee:

> Since noncancellable contracts of health and accident insurance require the accumulation of substantial reserves against increased future risks, the writing of such insurance is analogous to life insurance and the definition has been changed to permit such companies to be taxed as life insurance companies. The unearned premiums and unpaid losses on noncancelable life, health, or accident policies, not included in life insurance reserves, are added to such reserves in determining whether a company is to be considered a life insurance company. The life insurance reserves defined in subsection (c)(2) as they pertain to noncancelable health and accident insurance policies are those amounts which must be reserved, in addition to unearned premiums, to provide for the additional cost of carrying such policies in the later years when the insured will be older and subject to greater risk and when the cost of carrying the risk will be greater than the premiums then being received. As the term is used in the industry, a noncancelable insurance policy means a contract which the insurance company is under an obligation to renew at a specified premium, and with respect to which a reserve in addition to the unearned premium must be carried to cover the renewal obligation.

S. Rep. No. 1631, 77th Cong., 2d Sess. 144-45 (1942).[27] In the present statute, this change is reflected in § 801(a)(2).

Plaintiffs attack Treasury Regulation § 1.801-3, which defines "noncancellable" for purposes of the insurance company qualification ratio, as an invalid exercise of the Treasury's rule-making authority because it has no support in the legislative history of § 801. Treasury Regulation § 1.801-3 provides in pertinent part:

> (c) *Noncancellable life, health, or accident insurance policy.* The term "noncancellable life, health, or accident insurance policy" means a health and accident contract, or a health and accident contract combined with a life insurance or annuity contract, which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premiums (as defined in paragraph (e) of this section) must be carried to cover that obligation. . . .

We do not perceive how this regulation can be said to lack legislative support with regard to the relevant feature—namely, a policy "with respect to which a reserve in addition to the unearned premiums . . . must be carried to cover that obligation." It is the necessity of an equalization fund in long term H & A coverage which compels the same treatment as that accorded life insurance reserves. Taxpayers did not establish an equalization fund in addition to the unearned premium reserves because the change in policyholders' health over the term of these policies was, as plaintiffs' expert testified, imperceptible.

Taxpayers argue that, although a separate "additional reserve" is not established, the obligation is built into the net premium (morbidity element) and thus into the unearned premium reserve. If the change in health is imperceptible, it is not apparent why a factor designed to equalize the cost of carrying the insurance risk would be included when that risk remains constant. Even assuming that taxpayers built a factor into the premiums for increasing risk over time, this must have been in effect

[27] *See generally United Benefit Life Ins. Co.* v. *McCrory*, 414 F.2d 928 (8th Cir. 1969), *cert. denied*, 396 U.S. 1039 (1970).

a charging of a "nonlevel" premium since no interest was expected on the temporary accumulation under the debenture arrangement. This factor differs substantially from the usual equalization fund, which depends on investment returns to insure the adequacy of the reserve against contract obligations. The interest portion necessary for policy obligations is recognized as an integral part of such reserves and therefore exempted from tax.[28]

Taxpayers further contend that in the insurance industry "noncancellable" means a policy which the insurance company cannot cancel and that Congress intended the meaning attached by the business which evolved the term. But Congress was specific as to the combined features of a "noncancellable" policy for tax purposes. Taxpayers' policies do not fit within the framework of the statutory definition.[29]

Plaintiffs also argue that since the H & A coverage could only be obtained if life insurance was also purchased, this constitutes a "health and accident contract combined with a life insurance . . . contract." Even assuming these were combined contracts, taxpayers still fail to meet the equalization fund requirement. See Rev. Rul. 60-54, 1960-1 CUM. BULL. 266. This requirement is perfectly consistent with the tax objective of § 801 and

[28] Where H & A policies are noncancellable in the sense that an additional reserve is required to be maintained, it appears that, although the entire unearned premium reserve is to be taken into account in determining whether an insurance company qualifies as a life insurance company under § 801(a) (REV. RUL. 69-270, 1969-1 CUM. BULL. 185), only the "reserve in addition to unearned premiums" on noncancellable or guaranteed renewable H & A contracts may be treated as a life insurance reserve for purposes of computing the policyholders' share of investment yield under § 804 and § 805(a)(1). REV. RUL. 70-460, 1970-2 CUM. BULL. 135.

This interpretation is in harmony with legislative intention when Congress first determined that the equalization fund aspect of noncancellable H & A policies mandated special treatment.

"Technical changes are made . . . to emphasize the fact that the unearned premiums and unpaid losses on noncancellable life, health, or accident policies, not included in life insurance reserves, are included *for purposes of the definition of a life insurance company only.*" S. Rep. No. 1631, 77th Cong., 2d Sess. 144 (1942) (emphasis added).

[29] *See also*, REV. RUL. 60-54, 1960-1 CUM. BULL. 266, involving insurance contracts similar to those in this case. Contracts not terminable at the company's option do not qualify for life insurance reserves where there is no equalization fund obligation.

the expressed intent of Congress.[30] *Group Life & Health Ins. Co.* v. *United States*, 434 F.2d 115 (5th Cir. 1970), *cert. denied*, 402 U.S. 944. *See also* Rev. Rul. 71-367, 1971-2 CUM. BULL. 258 (H & A policies do not qualify as guaranteed renewable during the first three years where reserves consisted of only gross unearned premiums but qualify thereafter where additional separate reserve established).

B. *Correct Measurement of the Unearned Premium Reserve*

Taxpayers' final contention is that only the morbidity portion (net premium) of unearned premium reserves should be added to the denominator (total reserves) of the reserve-ratio fraction. They argue that, since the life insurance reserves included in the ratio are based on net premiums (mortality element), including only the morbidity element of H & A unearned premium reserves is the only way to provide an adequate basis for comparison of the two types of businesses represented by reserves.

"Total reserves" are defined as "(1) life insurance reserves, unearned premiums and unpaid losses . . . and (3) all other insurance reserves required by law." 26 U.S.C. § 801(c). Treasury Regulation § 1.801-3(e) defines unearned premiums as "those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance."

Revenue Ruling 69-270 (1969-1) CUM. BULL. 185), dealing with qualification under § 801(a), cites numerous cases holding that "[t]he term 'unearned premiums' has long been established as being the full amount of the pro rata unearned premiums, unreduced by 'loading.'" The ruling concludes that "[t]he definition of 'unearned premiums' in section 1.801-3(e) of the regulations is substantially similar to that considered in the cases cited above where the courts, in discussing unearned premiums,

[30] We need not reach plaintiffs' argument that a termination date of 60 years or over is arbitrary since the policies in issue do not meet the additional reserve requirement. See Rev. Rul. 56-476, 1956-2 CUM. BULL. 468, which suggests that the Service was under the impression that it was expanding the definition of noncancellable in accordance with industry practice by including contracts which specified a termination date.

considered them to be the full pro rata gross unearned premiums." Furthermore, insurance regulators universally consider the entire pro rata portion of gross H & A premiums which apply to periods beyond the valuation date as "unearned." Consequently, insurance companies do not hold morbidity reserves, they hold unearned premium reserves.[31]

The conclusion of Revenue Ruling 69-270 implies that the phrase "cost of carrying the insurance risk" was inartfully employed[32] in Treasury Regulation § 1.801-3(e). Since we can find no instance where unearned premium reserve and the morbidity portion of the contract premium are used synonymously, we conclude that Congress intended to adopt the only definition attached to "unearned premium reserve" by the industry.[33]

VI

We conclude that taxpayers do not qualify as life insurance companies for purposes of taxation because the unearned premium reserves are attributable to them in the reserve-ratio qualification test as computed by the government. They are properly taxable as insurance companies other than life.

Reversed and remanded for proceedings consistent with this opinion.

Reversed And Remanded.

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[31] "Basing the reserve on gross rather than net premiums implies the assumption that expenses, like losses, are spread uniformly over the life of the policy. This is, of course, incorrect. By far the greatest portion of expenses are incurred at, or shortly after, the issuance of a policy. Commissions, underwriting, policy-writing, and group installation expenses are largely incurred and paid roughly at the time of issue. Since these expenses have already been paid, it is unnecessary to set up a reserve for their future payment. However, state laws require reserving on a gross premium basis. Thus the reserve is larger than it otherwise need be, and the earnings and surplus are understated as a result." DICKERSON at 386-87.

[32] If interpretation of the Treasury Regulation were strictly limited to the words "cost of carrying the insurance risk," this would encompass only the loading portion. If the regulation were to buttress taxpayers' argument, it would have to read "cost of the insurance risk." To accord with congressional intent and the industry's definition, it should read "cost of carrying the insurance risk plus the cost of the insurance risk."

[33] *Cf. Superior Life Ins. Co. v. United States*, 462 F.2d 945, 951 (4th Cir. 1972).

STEVENS, *Circuit Judge*, dissenting. Congress could have selected any one of several different tests for deciding when the life insurance portion of a company's business is sufficient to characterize the enterprise as a "life insurance company" for tax purposes. It might have used the number of life policies written, the amount of premium income, the face value of its policies, or possibly some combination of different yardsticks.[1] Instead, it chose to attach significance to the relative importance of the company's life insurance reserves.

Perhaps another test would have been preferable, but the reserve-ratio test does have certain advantages. Insurance companies are regulated by state authorities who require them to maintain adequate reserves. There is, therefore, an independent basis for believing that the amount of an insurance reserve is a realistic measure of the insurance risks the company has been paid to assume. For the reserve is not appropriate until the company (a) has assumed the risk, and (b) has been paid for assuming that risk. The amount which it is paid, usually in the form of a premium which has not yet been earned because it applies to future risks, provides the company with the wherewithal to acquire the assets to hold in reserve.

The test supplied by Congress to identify a life insurance company is a rather simple one and, as I understand it, these taxpayers passed it. If over half of an insurance company's total reserves consist of "life insurance reserves,"[2] it is a life insurance company within the meaning of the statute. In this case about 90% of the taxpayers' total reserves were life insurance reserves, and therefore they passed the statutory test by a comfortable margin.

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[1] It would surprise me if Congress should select a yardstick defined in terms of the amount of premiums received by a third party, rather than by the taxpayer, without setting forth a further test to indicate when "the arithmetic mean as of the beginning and end of each year" of the third party's revenues should be treated as though they belonged to the taxpayer.

[2] The statutory definition also permits "unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life health, or accident policies" to be treated as life insurance reserves for definitional purposes, but that component of the formula may be disregarded in this case since about 90% of each taxpayer's total reserves consisted of life insurance reserves.

The government does not dispute taxpayers' calculation of the amount of their life insurance reserves. For each taxpayer, however, the government argues "its" life insurance reserves were less than 50% of "*its* total reserves"[3] because the total reserves as reflected on its balance sheet should be increased to include a reserve for unearned permiums on health and accident insurance written by Standard. If I correctly understand the government's argument, it rests on two incorrect assumptions: (1) an implicit assumption that taxpayers receive unearned premiums on their health and accident business; and (2) an express assumption that taxpayers were at all times "'fully' on the [health and accident] risk."

For purposes of analysis we may treat Standard as the taxpayers' only customer and note that they sold only two kinds of policies to Standard. We may assume that a prototype of each policy provided insurance protection of $7,000 for a period of 21 months at a premium cost of $210. With respect to the life insurance policy, the full $210 premium was paid by Standard to taxpayer at the beginning of the policy term. At the outset taxpayer was therefore in possession of a $210 asset which had not yet been earned, but which was available to support a reserve liability of no more than $210. Such a reserve could then be amortized as the already-collected premium was earned at the rate of $10 per month.

With respect to the health and accident insurance, however, the full premium was not paid to taxpayer by Standard at the beginning of the term. The premium was paid as it was earned—in our example, at the rate of $10 per month. Since taxpayer did not receive any unearned premium on its health and accident business, it had no occasion to set up any reserve against unearned premiums.

On their life insurance business taxpayers could not terminate their risk by cancellation of a policy before the expiration of its term. They were therefore required by applicable state law to maintain, and did in fact maintain, life insurance reserves against the unearned premi-

[3] The quoted words are from the test prescribed by Congress in § 801(a). See Judge Sprecher's opinion, text at footnote 13.

ums which they had collected. On the health and accident business, however, they retained an unqualified cancellation right and did not assume any present risk on the unearned or unexpired portions of the policies. They were not required by state law to maintain, and did not maintain, health and accident reserves against risks they did not assume and for which they had collected no premiums.

Unlike the taxpayers, Standard, as the primary insurer, was required to maintain reserves with respect to health and accident policies which it had sold to customers of the finance companies. It was essential for Standard to maintain such reserves because it received the entire premium on such policies when they were issued and, only as those premiums were earned, did Standard use those funds to purchase re-insurance coverage from the taxpayers. Standard was the only insurer on the unearned, future portions of the health and accident risk for which premiums had been paid to Standard but not to taxpayers. Whether we apply the reserve ratio test to reserves which taxpayers actually maintained, to the reserves which they were required by state law and by good accounting practice to maintain, or to risks that they actually assumed *at any relevant point in time* against which reserves might appropriately have been created, I find no basis for calculating taxpayers' ratio of life insurance reserves as less than half of their total reserves.

I disagree with the government's conclusion that taxpayers were fully on the health and accident risk at all times. The government's conclusion depends on the suggestion that taxpayers' cancellation rights under the health and accident treaties were "illusory." I may misunderstand the suggestion, but it seems to rest on two quite different grounds. First, in essence, the government seems to claim that notwithstanding the fact that Standard and taxpayer were independently owned and dealt with one another at arm's length, the economics of the entire arrangement made it so unlikely that either taxpayer would ever cancel its health and accident re-insurance treaty that its clear right to do so should be equated with a

legal obligation not to do so.[4] In my opinion, the contractual language should be accepted as controlling.[5]

Second, the government may read the health and accident treaty as imposing the entire risk on taxpayer in the event that cancellation should occur. It is true that under Article IX the taxpayer accepted some of the risk on claims arising subsequent to cancellation, but the amount of the risk so accepted is limited to 10% of the total health and accident premiums earned by taxpayers during the one-year period prior to cancellation of the treaty. This exposure is, of course, far short of being "fully" on the risk. Indeed, it is quite clear that even if the taxpayers had been required to increase their total reserves in an amount sufficient to reflect 100% of this contingent liability, such an increase would not have been nearly sufficient to make the total reserve twice as large as the life insurance reserve.[6]

In sum, I am persuaded that the government's conclusion that life insurance represents less than half of taxpayers' total insurance business rests on a non-statutory standard. Congress may have acted unwisely in giving preferential tax treatment to life insurance companies, and it may have been unwise to select a reserve-ratio test as the definition of a life insurance company for tax

[4] At page 20 of its brief, the government argues that "the cancellation provisions grant taxpayers only an illusory right to avoid the risks." On the next page of its brief, purportedly stating the same legal conclusion in a different way, the government emphasizes evidence which "negates any reasonable likelihood that taxpayers would ever cancel."

[5] Even if we accept the government's theory that we can safely predict that neither the taxpayers nor Standard will ever cancel the health and accident re-insurance treaties, and therefore taxpayers will continue to assume the risks on the health and accident policies as the premiums are earned, I would not ignore the anomaly of creating a hypothetical balance sheet on which taxpayers have a large reserve liability which is not matched by any cash or other asset reflecting the receipt of unearned premiums. Necessarily, the government not only attributes Standard's reserves to the taxpayers, but also must treat them as though they had received the entire health and accident premiums at the beginning of the policy terms instead of on a monthly basis as the premiums are earned.

[6] As an illustration, plaintiff's Exhibit 14 indicates that Standard paid $285,574.23 of health and accident premiums to United in 1961. Under the cancellation provisions of the reinsurance treaty, United therefore had a maximum contingent liability of $28,557.42 on the unearned portion of the health and accident risk. Even if this full amount were added to its reported total reserves of $336,215.63, its life insurance reserves, which amounted to $322,055.00, would be over 88% of the total.

purposes. Nevertheless, we must, of course, apply the test which Congress has specified. Although I do not question the majority's conviction that it is doing so faithfully, I am afraid the holding may actually rest on an amalgam of substitute tests that will be difficult to apply in other cases.[7] I therefore respectfully dissent.

A true Copy:

Teste:

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Clerk of the United States Court of Appeals for the Seventh Circuit.

[7] The principal element in the crucible appears to be an emphasis on the long-term investment income potential associated with "the dual nature of life insurance, serving both an insurance and a banking function." I do not understand, however, that term life insurance — which is the only kind of life insurance involved in this case — serves any such banking function. I am therefore inclined to believe that any analysis based on an attempt to effectuate the majority's understanding of the underlying rationale for special tax treatment for life insurance companies — rather than the statutory language selected by Congress — would lead to the disqualification of any company writing nothing but term life insurance.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

ECONOMY FINANCE CORPORATION, Transferee of the Assets of National Public Life Insurance Company,
Plaintiff,
v.
UNITED STATES OF AMERICA,
Defendant.
No. IP 68-C-295

UNITED PUBLIC LIFE INSURANCE COMPANY,
Plaintiff,
v.
UNITED STATES OF AMERICA,
Defendant.
No. IP 68-C-297

FINDINGS OF FACTS AND CONCLUSIONS OF LAW AND JUDGMENT ENTRY

[Entered July 25, 1972]

The issues of the July 30, 1968 complaint and the answer filed thereto on October 28, 1968 in Cause Number IP 68-C-295 with the issues of the July 30, 1968 complaint as amended May 15, 1970 and the answer thereto of June 18, 1970 in Cause Number IP 68-C-297 were submitted to the Court in a bench trial on April 20, 1972 and the evidentiary phase of the trial was concluded on the same day. Final arguments were waived and in lieu thereof briefs were filed, the last of which was received on July 6, 1972.

The captioned cases were but two of a group of related cases that were filed in 1968. The delay of these two cases in reaching trial was due to the sincere effort of both parties to compromise and settle the massive litigation. All of the actions were disposed of by compromise but the captioned cases. The parties having exhausted all efforts to compromise notified the Court of their needs for trial time in the spring of 1972.

The plaintiff, Economy Finance Corporation, (Economy Finance) in the captioned Cause Number IP 68-C-295, was at all times in question an Indiana corporation engaged in the consumer lending and finance business in the City of Indianapolis, State of Indiana. The stockholders at such times consisted of William L. Schloss, his wife, and various trusts of which the children of William L. Schloss were the primary beneficiaries. National Public Life Insurance Company, (National Life) (referred to in the caption of Cause Number IP 68-C-295 as the transferor of its assets to Economy Finance), until its dissolution on December 23, 1960, was a Delaware corporation engaged in the business of reinsurance. During the taxable year of National Public Life Insurance Company in issue, the taxable year 1959, it was a wholly owned subsidiary of Economy Finance Corporation. The plaintiff, United Public Life Insurance Company, (United Life) in the captioned Cause Number IP 68-C-297, was at all times in question a Delaware corporation engaged in the business of reinsurance. During the taxable years of United Public Life Insurance Company in issue, the taxable years 1959 and 1961, its sole stockholders consisted of Schloss Bros., a partnership, and various trusts of which the children of William L. Schloss were the primary beneficiaries.

The Federal income tax returns of National Life for the taxable year 1959 and of United Life for the taxable years 1959 and 1961 were timely filed with the District Director of Internal Revenue at Indianapolis, State of Indiana, on or before the due date thereof, and the taxes shown thereon to be due defendant were timely paid. On their returns for those years, as well as every other year between their formation in 1957 and, in the case of National Life, its dissolution on December 23, 1960, or, in the cause of United Life, the year 1961, each computed its income tax liability on the premise that it qualified for

taxation as a life insurance company under the provisions of Section 801(a) of the Internal Revenue Code of 1954 which was in effect during the taxable years in question. The Commissioner of Internal Revenue determined by notices of deficiency, and addressed, deficiencies against Economy Finance, as transferee of the assets of National Life, and against United Life for the taxable years in issue in the following respective amounts:

Taxpayer	Taxable Year Ended Dec. 31	Tax	Deficiency Interest	Total
National Life	1959	$125,600.61	$37,274.11	$162,874.72
United Life	1959	34,589.35	11,950.38	46,539.73
United Life	1961	45,046.36	10,041.02	55,087.38

The above deficiencies were based largely on a determination by the Commissioner of Internal Revenue that during the taxable years in issue National Life and United Life did not qualify for taxation as life insurance companies under Section 801 of the Internal Revenue Code of 1954. The plaintiff, Economy Finance Corporation, made payment of the 1959 tax deficiency and interest assessed against it as transferee of National Life as follows:

Tax	Interest	Date Paid
$125,600.61	$ 8,570.38	December 1, 1965
	28,703.73	December 27, 1965

United Life made payment of the 1959 and 1961 tax deficiencies and interest assessed against it as follows:

Taxable Year Ended Dec. 31	Tax	Interest	Date Paid
1959	$34,589.35	$11,950.38	February 28, 1966
1961	45,046.36	10,041.02	December 1, 1965

On June 8, 1966, the plaintiff, Economy Finance Corporation, filed with the District Director, Internal Revenue Service, at Indianapolis, State of Indiana, a claim for refund of taxes paid amounting to $25,001.82 and interest paid

amounting to $37,274.11. On November 30, 1967, the plaintiff, Economy Finance Corporation, filed with such District Director an amended claim for refund of taxes paid amounting to $125,600.61 and interest paid amounting to $37,274.11. On June 8, 1966, plaintiff, United Life, filed with the District Director, Internal Revenue Service, at Indianapolis, State of Indiana, claims for refund of taxes and interest in such amounts. The plaintiffs filed their complaints commencing their actions for such refunds on July 30, 1968.

National Life and United Life each had the authority under its Certificate of Incorporation to underwrite and reinsure life and accident and health insurance. The only business of National Life and United Life during the taxable years in issue consisted of the reinsurance of contracts of credit life, accident and health insurance. Credit life, accident and health insurance is single advance premium insurance on the lives and health of debtors, with the creditors of the insured debtors as beneficiaries. Credit life insurance insures the life of the debtor in an amount sufficient to discharge his indebtedness in case of death or dismemberment. Credit accident and health insurance insures the payment of the installments due on the debtor's indebtedness, as they mature, during periods of disability because of accident or sickness. The term of both kinds of credit insurance is coextensive with the term of the related loan. The term of the related loan was typically three years or less in these cases, and the average term of the related loan was 21 months. The contracts of credit life, accident and health insurance which were reinsured by National Life (during the taxable year 1959) were issued to insure the lives and health of loan customers of Indianapolis Morris Plan Corporation, a finance company doing business in the State of Indiana, which was related, in its ownership, to National Life, and other finance com-

panies and financial institutions doing business in various states which were not related to National Life. The contracts of credit life, accident and health insurance which were reinsured by United Life were issued to insure the lives and health of loan customers, during the taxable year 1959, of Economy Finance, together with finance company subsidiaries of Economy Finance doing business in various states, which corporations were related, in their ownership, to United Life, and, during the taxable year 1961, of such corporations together with Indianapolis Morris Plan Corporation, which was also related, in its ownership, to United Life, and other finance companies and financial institutions doing business in various states which were not related to United Life. (All of these finance companies and financial institutions are hereinafter referred to as the "finance companies.") The credit life, accident and health insurance contracts were originally underwritten by Standard Life Insurance Company of Indiana, an Indiana corporation engaged in the insurance business (Standard Life), which was not related to or controlled by National Life or United Life or any person or persons in control of or related to National Life or United Life. Standard Life issued the contracts through Schloss Insurance Agency, an Indiana general partnership owned by the Schloss family which was Standard Life's sole general agent for selling and processing claims for credit life, accident and health insurance. Schloss Insurance Agency received a commission as such general agent. The credit life, accident and health insurance reinsured by National Life and United Life was sold in connection with a separate transaction consisting of a loan made by one of the finance companies which became the beneficiary of the said insurance. Customers of the finance companies were afforded the opportunity to purchase credit life, accident and health insurance in order to secure the pay-

ment of their loans in the event of death or disability, but they were not required to purchase such insurance as a condition to securing a loan. When any customer of one of the finance companies desired credit life, accident and health insurance, such customer executed an application for such insurance which the finance company forwarded, together with the entire premium attributable to such insurance (less agents' commissions), to Schloss Insurance Agency. Schloss Insurance Agency then issued a policy underwritten by Standard Life and that policy was then reinsured by National Life (or United Life). When a customer of one of the finance companies purchased credit life, accident and health insurance, the amount of the insurance premium was added to—and treated as part of—the loan. The entire amount of the insurance premium was withheld by the finance company and was forwarded (except for the portion paid as agents' commissions) to Schloss Insurance Agency together with the insurance application. Thus, a customer of one of the finance companies who purchased life, accident and health insurance was charged the entire premium for the credit life, accident and health insurance when his debt was incurred. If the customer paid off his debt prematurely or died or suffered a dismemberment, he was credited or refunded a portion of the single advance premium paid when his debt was incurred, computed under the "Rule of 78." (Under the Rule of 78, the portion of the premium to be credited or refunded to the loan customer is determined by applying a changing fraction to the premium paid by the insured. The numerator of the fraction changes each month to a number which corresponds to the remaining unexpired term of the policy, and the denominator which remains constant, is the sum of all the months' digits corresponding to the entire term of insurance coverage. For example, if the entire term of insurance cov-

erage is 21 months, the sum of the months' digits is 231. At the end of one month, the portion of the premium to be refunded is $\frac{231-21}{231}$ or $\frac{210}{231}$ thereof.)

Each policy of credit *life* insurance which was written by Standard Life and reinsured by National Life or United Life was reinsured pursuant to Reinsurance Treaties entered into by Standard Life and National Life on July 24, 1957 and entered into by Standard Life and United Life on October 28, 1957. Each policy of credit *accident and health* insurance which was written by Standard Life and reinsured by National Life or United Life was reinsured pursuant to Reinsurance Treaties entered into by Standard Life and National Life on July 25, 1957 and entered into by Standard Life and United Life on October 29, 1957. Under the terms of the Reinsurance Treaties entered into by Standard Life and National Life (or United Life) with respect to credit *life* insurance, Standard Life ceded to National Life (or United Life) 100 percent of each credit life insurance policy issued by Standard Life with respect to the customers of the finance companies. The National Life treaty applied to policies issued by Standard Life on or after August 1, 1957, while the United Life treaty applied to policies issued by Standard Life on or after November 1, 1957. Effective November 1, 1960 all of the reinsurance of credit life insurance which had been ceded to National Life under the Reinsurance Treaty dated July 24, 1957 between Standard Life and National Life was cancelled and the business recaptured by Standard Life. By an agreement dated October 31, 1960 Standard Life ceded that insurance to United Life effective November 1, 1960. Under the terms of each credit life Reinsurance Treaty, Standard Life agreed to pay to National Life (or United Life) a reinsurance premium on each of the policies reinsured equal to 98.3 percent of

"gross monthly *paid* premiums" thereon as defined in the treaty, less commissions paid to agents thereon, such payment to be made monthly on or about the 20th day of each month, on the basis of "gross monthly paid premiums" for the preceding month. "Gross monthly paid premiums" were defined in the treaties as the full premiums on all policies issued less premiums refunded on any credit life policies which were cancelled. Standard Life was required at the same time to furnish a statement showing the gross monthly paid premiums, as defined in the treaty, for the month preceding the month in which the statement was given, together with the amount of credit life insurance written and cancelled during the preceding month, and the losses paid by Standard Life during the preceding month. At the same time as the statement was to be given by Standard Life to National Life (or United Life) and the reinsurance premium was to be paid, Standard Life was to submit a bill to the reinsurer (National Life or United Life) for all losses paid by it during the preceding month and for its direct demonstrable expenses including taxes, claims expense, printing, etc. paid in the preceding month. Each reinsurer was to reimburse Standard Life for those losses and expenses as reflected by the bill before the 30th day of the month in which the bill was submitted. Under the terms of the Reinsurance Treaties entered into by Standard Life and National Life (or United Life) with respect to credit *accident and health* insurance, Standard Life ceded to National Life (or United Life) 100 percent of each credit accident and health insurance policy issued by Standard Life with respect to the customers of the finance companies. Each accident and health Reinsurance Treaty provided, by contrast with the credit life reinsurance treaties, that "It is understood that NATIONAL [or UNITED] is reinsuring said risks for a period of one month only; provided, however, that this

agreement shall automatically renew itself from month to month until such time as the individual policies covered by this treaty run out, lapse, are cancelled or in any way terminate; or until this treaty is cancelled as provided in ARTICLE IX, NATIONAL [or UNITED] shall have no right, title or interest in any unearned premiums or unearned premium reserves held by STANDARD." The National Life treaty applied to policies issued by Standard Life on or after August 1, 1957, while the United Life treaty applied to policies issued by Standard Life on or after November 1, 1957. Effective November 1, 1960 all of the reinsurance of credit accident and health insurance which had been ceded to National Life under the Reinsurance Treaty dated July 25, 1957 between Standard Life and National Life was cancelled and the business recaptured by Standard Life. By an agreement dated October 31, 1960 Standard Life ceded that insurance to United Life effective November 1, 1960. Under Article IV of each credit accident and health Reinsurance Treaty, Standard Life agreed to pay to National Life (or United Life) a reinsurance premium on each of the policies reinsured equal to 98.3 percent of "gross monthly *earned* premiums" thereon as defined in the treaty, less commissions paid to agents thereon, and less Standard Life's direct demonstrable expenses including taxes, claims expense, printing, etc., such payment to be made monthly on or about the 20th day of each month, on the basis of "gross monthly earned premiums," for the preceding month. The "gross monthly earned premiums" on any policy was defined in Article III-1 of each treaty as "the pro rata part of the single premium corresponding to the duration of insurance coverage provided for in said policy during the preceding month." Standard Life was required at the same time to furnish a statement showing the gross monthly earned premiums, as defined in the treaty, for

the month preceding the month in which the statement was given together with the losses paid by Standard Life during the preceding month. At the same time as the statement was to be given by Standard Life to National Life (or United Life) and the reinsurance premium was to be paid, Standard Life was to submit a bill to the reinsurer (National Life or United Life) for all losses paid by it during the preceding month. Each reinsurer was to reimburse Standard Life for those losses as reflected by the bill before the 30th day of the month in which the bill was submitted. Both the credit life Reinsurance Treaties and the credit accident and health Reinsurance Treaties gave the right to the reinsurers, National Life and United Life, to cancel each treaty at any time by giving Standard Life 30 days' prior written notice of such cancellation. Each of the credit *life* Reinsurance Treaties provided that such cancellation should not affect any policies written (and reinsured) under such treaties prior to the effective date of cancellation of the treaty. But the liability of National Life (or United Life) in the event of the cancellation of the credit *accident and health* Reinsurance Treaties was strictly limited by the terms of those treaties. In the event of cancellation of either of the credit accident and health Reinsurance Treaties it was provided that:

> "STANDARD shall pay to NATIONAL [or UNITED] within 30 days after date of such cancellation the total of all earned portions of single premiums as of the date of such cancellations [sic], for such policies less an unpaid claim reserve. Such unpaid claim reserve shall be an amount estimated by STANDARD to be sufficient to pay all claims and expenses reimbursable hereunder for losses incurred or unreported and unpaid at the date of such cancellation. On the date six months after such cancellation an accounting shall be made of such claims paid and STANDARD shall thereupon pay to NATIONAL [or UNITED] any excess

of the aforesaid claim reserve over such claims actually paid, together with expenses reimbursable hereunder, conversely, NATIONAL [or UNITED] shall pay to STANDARD any excess paid by it for such claims and expenses incident thereto over and above the aforesaid claim reserve whereupon all liability of the parties each to the other shall cease and determine."

Article IX of the treaty provided that:

"If NATIONAL [or UNITED] cancels this treaty as provided for [herein], and should the claims and expenses subsequently incurred and paid in connection with all business covered under this treaty then in force carried by STANDARD, plus one and seven-tenths per cent (1 7/10%) of unearned gross premiums on such date of cancellation, exceed the unearned net premiums held by STANDARD on the date of cancellation, then NATIONAL [or UNITED] will, thirty (30) days after the expiry of all such insurance contribute to STANDARD a sum that would be necessary to reimburse STANDARD for the following items only to the extent that the total of such items exceed the unearned net premiums held by STANDARD on the date of said cancellation, but in no case more than 10% of the total premiums earned by NATIONAL [or UNITED] during the twelve (12) months immediatedly preceding the date of cancellation of this Contract:

1. One and seven-tenths percent (1 7/10%) of such gross unearned premiums.
2. STANDARD's direct demonstrable expenses incurred after such effective date of cancellation.
3. Losses paid and incurred on all insurance written under this treaty not recovered through reinsurance with NATIONAL [or UNITED].

The additional amount to be so retained by STANDARD, if any, shall be refunded to STANDARD by NATIONAL [or UNITED] on demand, any time before one (1) year after the expiration of the last of said policies.

STANDARD shall have the right to retain all premiums unearned at the date of cancellation."

During the taxable years in issue, National Life and United Life were subject to regulation under the laws of the State of Delaware respecting life insurance companies. For each of the said taxable years National Life (and United Life) each filed its Annual Statement on the form prescribed by the National Association of Insurance Commissioners with the Insurance Commissioner of the State of Delaware, as required by the laws of that state, and a copy of said Anuual Statement was duly filed by National Life (or United Life) along with its Federal income tax return for such year. Neither National Life nor United Life reported any portion of the reinsurance premiums not yet due from Standard Life to either of such reinsurers under the terms of the accident and health Reinsurance Treaties in their accident and health insurance premiums and reserves on their Annual Statements. National Life in error reported an "unearned premium reserve" on line 1, Part 1, Exhibit 9 (page 11) of its 1959 Annual Statement amounting to $24,319.32. That amount represented a reserve for the "present value of amounts not yet due on claims" of persons who were disabled at year-end and should have been reported on line 3, rather than line 1. The same mislabeling of the nature of the reserve took place in the 1958 Annual Statement. The error is not material to the issues in this case. Standard Life on its Annual Statements showed the reinsurance premiums not yet due as a liability described as "Accident and Health Reinsurance Premiums Contracted." In 1969 as a result of an examination by the California Insurance Department Standard Life corrected its treatment of the reinsurance premiums not yet due by showing the amount of such reinsurance premiums not yet due as an "unearned premium reserve." During the taxable years in issue the reinsurance premiums not yet due should technically have been shown in Standard Life's

Annual Statement as "unearned premium reserve" liabilities rather than as non-reserve liabilities. On its Federal income tax return for 1959, National Life reported its life insurance reserves as $184,928.50 (mean balance) and its total reserves as $204,334.37 (mean balance). The respective portions of the reserves reported on National Life's Annual Statement which were thus treated as life insurance reserves, or total reserves, on its Federal income tax return are properly includible in "life insurances reserves," or "total reserves," as defined in Section 801 of the Internal Revenue Code of 1954. In its adjustment of National Life's 1959 Federal income tax return, the Internal Revenue Service did not adjust National Life's reported "Life insurance reserves" but the Service did adjust United Life's reported "total reserves," increasing the reported amount of those reserves (mean balance) by $57,025.60 for the taxable year 1959 and (mean balance) $336,211.14 for the taxable year 1961. The $305,726.75, $57,025.60, and $336,211.14 respective amounts by which the Internal Revenue Service increased National Life's and United Life's reported "total reserves" represents in each case an amount equal to the arithmetic mean of the gross monthly *unearned* credit accident and health insurance premiums (after commissions and refunds on cancellations, all as of December 31, 1958 and 1959 or as of December 31, 1960 and 1961) which had been received by Standard Life but which, under the terms of Article IV of each of the credit accident and health Reinsurance Treaties were not yet due to be paid to National Life (or United Life) because the reinsurance premium due from Standard Life to National Life (or United Life) on each credit accident and health policy was to be paid on or about the 20th day of each month, in an amount equal to the gross monthly *earned* premiums (after commissions and expenses), attributable to the insurance coverage provided during the preceding month.

The credit life and accident and health insurance treaties between Standard Life and National Life (or United Life) are not unusual in the credit insurance industry. It is not unusual for credit life insurance to be reinsured under a treaty under the terms of which the reinsurer assumes the entire risk under each credit life insurance policy as it is issued to the customer and accordingly is to receive the entire reinsurance premium with respect to that policy at the outset or close to the outset of coverage under the policy, but assumes the risk under each accident and health insurance policy not as the policy is issued to the customer but only on a month-to-month basis and accordingly is to receive pro rata reinsurance premiums with respect to that policy only after each month expires for which the reinsurer has assumed the risk. Even outside the credit insurance area, there is nothing unusual about a reinsurance arrangement under which the risk assumed by the reinsurer (and accordingly the payment of reinsurance premiums) is on a month-to-month basis. For example, the reinsurer may not be an authorized reinsurer in the state in which the ceding company (the company which writes the policy) does business. If the entire risk under the policy were reinsured at the outset and the reinsurance premium were paid to the reinsurer, the ceding company would be bereft of the funds paid out as the reinsurance premium and yet at the same time would be required by the insurance regulatory authorities to set up a reserve liability for the risk under the policy, i.e., would be denied a deduction for reserves which are maintained by the reinsurer receiving such funds because of such reinsurer's unauthorized status. Thus reinsurance on a month-to-month basis is not an uncommon or unaccepted reinsurance arrangement. The monthly assumption of risk and the concomitant remittance of reinsurance premiums on a monthly basis helps

the cash flow of the *ceding* company—here, Standard Life—since it collects the full premium (minus agents' commissions) when each policy is written but is only required to remit on a monthly basis to the reinsurer. Such an arrangement results in greater liquidity and a better balance sheet for the ceding company. Thus, in the instant case, Standard Life benefited by reinsuring its credit accident and health insurance on a month-to-month basis. Since it reinsured on that basis, the consequence was that it was enabled to retain the funds received from the finance companies in the form of premiums which had been received by them from the customers (after deduction of agents' commissions), only paying the reinsurance premiums out month by month over the policy term. Standard Life from time to time invested a sum equal to a substantial amount of the balance in the liability account which it maintained in the subordinated debentures of Economy Finance. An amount equal to the interest received by Standard Life on the subordinated debentures was paid as additional commission compensation to Schloss Insurance Agency. The net worth of Economy Finance at the end of each of its fiscal years (all ended September 30) 1958-1961 respectively amounted to $2,667,281.00, $2,770,332.00, $3,-006,246.00 and $4,300,102.00. The net worth of National Life at the end of the taxable year in issue, the taxable year 1959, amounted to only $423,209.71. The net worth of United Life at the end of the taxable years 1959 and 1961 amounted respectively to only $210,578.44 and $215,754.22. Standard Life benefited from remitting reinsurance premiums under the accident and health Reinsurance Treaties on a monthly basis, since (a) it thereby substituted a claim against Economy Finance for claims which it otherwise would have had against substantially smaller companies (National Life and United Life) and (b) that claim appeared as an asset on its balance sheet, enhancing

its image. National Life and United Life reinsured credit accident and health insurance on a month-to-month basis, rather than for the full term of the policies, in order to avoid holding any unearned accident and health premium reserves and, therefore, reduce the amount of reserves which might be considered as nonqualifying reserves for the purpose of determining whether they were entitled to be taxed as life insurance companies under the reserve ratio formula in Section 801(a) of the Internal Revenue Code of 1954. Since National Life and United Life could not have underwritten credit life, accident and health insurance directly (due to lack of qualification in all of the states involved and inadequate capital and surplus), they arranged with Standard Life (which was qualified and adequately capitalized) to write that business directly and reinsure it with them for the full term in the case of credit life insurance and on a month-to-month basis in the case of credit accident and health insurance, with renewal and cancellation provisions as explicitly set forth in the Reinsurance Treaties. The solvency of National Life and United Life would have been endangered if they had either directly written the credit accident and health insurance which they reinsured for Standard Life or if the reinsurance premiums had been payable in full as each policy was issued to the customer. For example, United Life for the taxable year 1961 would have been insolvent if either of those alternatives had been the arrangement chosen. The reason for this is that while the assets of United Life would have been enhanced by the amount of the gross premiums received from customers, but only after those gross premiums received had been reduced by agents' commissions, United Life would have been required by the insurance regulatory authorities to establish an unearned premium reserve in an amount equal to the gross premiums received from the

customers. United Life's net worth as shown on its annual statement for 1961 was $215,754.22. The gross unearned premium reserve which United Life would have been required to establish for 1961 would have been $670,000.00. Its assets would have been increased by the liability account on Standard Life's books amounting to $292,872.29. Thus, United Life would have been insolvent since its liabilities would have exceeded its assets by some $161,000.00. On the basis of the foregoing, both Standard Life, the ceding company, and National Life and United Life, the reinsurers, had substantial non-tax business purposes for reinsuring credit accident and health risks on a month-to-month basis. An unearned premium reserve is required to be established only with respect to that portion of the premium (or reinsurance premium) which has been received by the insurance company prior to the expiration of the period of coverage to which that premium relates. An insurance company is not required to establish an unearned premium reserve with respect to premiums or reinsurance premiums to be received in the future. Since under the terms of the accident and health Reinsurance Treaties reinsurance premiums were due from Standard Life to National Life and United Life only in the month succeeding the month for which the two reinsurers assumed the risk on the credit accident and health insurance policies issued by Standard Life, those reinsurance premiums were fully earned when received. It therefore would have been improper for National Life or United Life to establish any unearned premium reserve. Since National Life and United Life received only reinsurance premiums which represented payments for the assumption of insurance risks by those companies which had already expired by each reserve date, they were not required to set up unearned premium reserves. No state regulatory agency would have required National Life or

United Life to set up unearned premium reserves with respect to the credit accident and health insurance which was issued by Standard Life and reinsured by National Life and United Life. Even without the cancellation provisions in the credit accident and health Reinsurance Treaties, it would not have been proper for National Life or United Life to set up unearned premium reserves since under the terms of those treaties they reinsured risks on a month-to-month basis. Since under the terms of the credit accident and health Reinsurance Treaties National Life or United Life were given the right to cancel the treaties upon giving 30 days' notice, in which event they would have been subject to only a limited amount of liability on policies then in force, an additional reason exists for their not being required to establish unearned premium reserves.

The parties have resolved by settlement all issues except for the issue as to whether, for the taxable years in issue, National Public Life Insurance Company and United Public Life Insurance Company qualified for taxation as life insurance companies under the reserve ratio test set forth in Section 801(a) of the Internal Revenue Code of 1954. Specifically, the parties have resolved by settlement other issues involving the plaintiff's, Economy Finance's, income tax liability as transferee of National Life and plaintiff's, United Life's, income tax liability for the taxable years in issue, as follows:

> That for the taxable years 1959 and 1961 National Life and United Life are each allowed the surtax exemption under section 11(c) of the Internal Revenue Code of 1954.
>
> That the accumulated earnings tax referred to in section 531 of the Internal Revenue Code of 1954 is not imposed upon National Life for the taxable year 1959. That Economy Finance is entitled to a refund, with respect to the additional interest paid (on the deficien-

cy for the taxable year 1959) on December 27, 1965 to the extent of $22,667.69. Of the total interest of $37,-274.11 which was paid with respect to the 1959 tax deficiency, the correct amount of interest is $14,-606.42, so that the overpayment of interest which occurred on December 27, 1965 amounts to $22,667.69.

For purposes of this case only, United Life's loss from operations for the taxable year 1964 is agreed to be $131,208.76 as determined in a Revenue Agent's Report dated March 20, 1968 issued to United Life. Such loss will be treated as a carryback in that amount to the taxable year 1961 and treated as deductible under sections 809(d)(4) and 812 of the Internal Revenue Code of 1954 in computing United Life's life insurance company taxable income, if it is determined that United Life is taxable as a life insurance company for the taxable year 1961, as deductible under section 832(c)(10) of the Internal Revenue Code of 1954 in computing its taxable income, if it is determined that it is taxable as an insurance company other than life for that taxable year, or as deductible under section 172 of the Internal Revenue Code of 1954 in computing its taxable income if it is determined that it is not taxable as an insurance company for that taxable year.

United Life is allowed a deduction for expenses amounting to $51,587.63 for the taxable year 1961 consisting of an amount paid to Economy Finance for various ordinary and necessary business expenses.

National Life and United Life are each entitled to a compensating adjustment under section 482 of the Internal Revenue Code of 1954 with respect to any income reported by National Life or United Life on their federal income tax returns for the taxable years in issue (1959 and 1961) (or for any other taxable year, including the taxable year of United Life 1964, where the effect will be to give rise to an operations loss and net operating loss carryback or carryforward to either of the taxable years 1959 and 1961) which

> the defendant may have properly reallocated to any other entity, corporation, individual, partnership, trust, estate, or otherwise for those years. These compensating adjustments need not be made by defendant until such time as a final determination concerning the propriety of the reallocation is made by a court of proper jurisdiction or by settlement.

The parties have also agreed that neither Section 269 nor Section 1551, which sections were referred to in the notices of deficiency hereinafter referred to, is pertinent to the determination of whether National Life (or United Life) was a life insurance company as defined in Section 801 of the Internal Revenue Code of 1954 for the taxable years in issue.

The plaintiffs have maintained their burdens of proof by a preponderance of the evidence of the essential elements and the alleged facts of each of the elements of their complaints.

The Court has jurisdiction of the parties and subject matter of the two actions. Title 28 U.S.C. Section 1346(a)(1).

National Public Life Insurance Company and United Public Life Insurance Company constituted "life insurance companies" during the taxable years in issue and hence were subject to the tax imposed by Title 26 U.S.C. Section 802(a)(1). These life insurance companies qualify for taxation under the "reserve ratio" test set forth in Title 26 U.S.C. Section 801(a).

No part of the reinsurance premiums not yet due from Standard Life Insurance Company to National Public Life Insurance Company and United Public Life Insurance Company under the terms of the credit accident and health Reinsurance Treaties to which those insurance companies were parties is includible in the premium income or in the unearned premium reserves of National Public Life Insurance

Company and United Public Life Insurance Company. The numerator and denominator of the qualifying fraction under Title 26 U.S.C. Section 801(a), and accordingly the qualifying fraction expressed as a percentage, with respect to each of the taxable years in issue of National Public Life Insurance Company and United Public Life Insurance Company are as follows:

Taxpayer	Taxable Year	Numerator	Denominator	Percentage Qualifying Ratio (1) ./. (2)
National Life	1959	$184,928.50	$204,334.37	9[illegible].50%
United Life	1959	23,497.00	26,561.79	88.46%
United Life	1961	322,055.00	336,215.63	95.79%

It follows that National Public Life Insurance Company and United Public Life Insurance Company each constitute life insurance companies as defined in Title 26 U.S.C. Section 801(a) for each of the taxable years in issue.

The law is with the plaintiffs and against the defendant.

The plaintiffs are entitled to a judgment for a refund of taxes and deficiency interest paid for the tax years in question together with interest thereon from the date of deficiency payment and Court costs.

JUDGMENT

It is hereby ORDERED AND ADJUDGED as follows:

It is expressly determined, in accordance with Rule 54(b) of the Federal Rules of Civil Procedure, that there is no just reason for delay in the entry of final judgment and it is expressly directed that judgment be entered on all claims for relief presented in these actions other than those presented in paragraph 18 of the complaint filed in Cause Number IP 68-C-295 and paragraph 20 of the complaint filed in Cause Number IP 68-C-297. Judgment on

those claims shall be entered at such time as the further amounts recoverable under such paragraphs are determinable, all in accordance with paragraph 30(c) of the Stipulation of Facts dated March 9, 1972 in Cause Number IP 68-C-295 and paragraph 30(c) of the Stipulation of Facts dated March 9, 1972 in Cause Number IP 68-C-297.

Economy Finance Corporation, plaintiff in Cause Number IP 68-C-295, shall have and recover of defendant, United States of America, the sum of $134,170.99, with interest thereon for the period commencing on December 1, 1965 at the rate of 6 percent as provided by law, together with the sum of $28,703.73, with interest thereon for the period commencing on December 27, 1965 at the said rate and as provided by law, and together with its costs.

United Public Life Insurance Company, plaintiff in Cause Number IP 68-C-297, shall have and recover of defendant, United States of America, the following sums with interest thereon for the period commencing on the following respective dates at the rate of 6 percent as provided by law, together with its costs:

Sum	Interest Commencement Date
$ 5,042.68	January 1, 1965
55,087.38	December 1, 1965
46,539.73	February 28, 1966

Dated this 25 day of July, 1972.

/s/ Cale J. Holder
Judge
United States District Court
Southern District of Indiana

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604

Before

Hon. JOHN PAUL STEVENS, *Circuit Judge*
Hon. ROBERT A. SPRECHER, *Circuit Judge*
Hon. WILLIAM J. CAMPBELL, SR., *District Judge*

ECONOMY FINANCE CORPORATION, etc., UNITED PUBLIC LIFE INSURANCE CO.,
Plaintiffs-Appellees,
Nos. 72-2024, 72-2025 vs.
UNITED STATES OF AMERICA,
Defendant-Appellant.

Appeal from the United States District Court for the Southern District of Indiana, Indianapolis Division.
(IP 68 C 295)

[Entered September 6, 1974]

On consideration of the petition for rehearing and suggestion that it be reheard *en banc* filed in the above-entitled cause, no judge in active service having requested a vote thereon, nor any judge having voted to grant the suggestion, and all of members of the panel having voted to deny a rehearing,

IT IS ORDERED that the petition for a rehearing in the above-entitled cause be, and the same is hereby, DENIED.

In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-701

ECONOMY FINANCE CORPORATION, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. App. A35-A56) is not officially reported. The opinion of the court of appeals (Pet. App. A1-A33) is reported at 501 F.2d 466.

JURISDICTION

The judgment of the court of appeals was entered on July 16, 1974 (see Pet. App. A1). A petition for rehearing was denied on September 6, 1974 (Pet. App. A57). The petition for a writ of certiorari was filed on December 4, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Section 801(a) of the Internal Revenue Code of 1954 provides that in order for an insurance company to qualify for tax treatment as a life insurance company, its

life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, health or accident policies not included in life insurance reserves must comprise more than 50 percent of its total reserves.

The question presented is whether the court of appeals correctly held that non-life insurance reserves should be attributed to petitioners for purposes of determining their qualification as life insurance companies under Section 801(a), where petitioners assumed the risk of the policies incident to such reserves pursuant to a reinsurance contract with another insurer.

STATUTE AND REGULATION INVOLVED

Section 801 of the Internal Revenue Code of 1954 and the pertinent provisions of Section 1.801-3 of the Treasury Regulations on Income Tax (1954 Code) are set forth at pages 4-5 of the petition.

STATEMENT

Petitioners were engaged in the business of reinsuring credit life and credit accident and health insurance. They reinsured the credit life and credit accident and health insurance issued by an independent insurer, Standard Life Insurance Company of Indiana ("Standard") (Pet. 5-6; Pet. App. A2, A38-A39). Under the arrangement, Standard reinsured 100 percent of the credit insurance risk with petitioners, pursuant to two separate reinsurance contracts, one for the credit life insurance and one for the credit accident and health insurance (Pet. 6; Pet. App. A3-A4). Under the life reinsurance contracts, Standard reinsured with petitioners 100 percent of each credit life insurance policy and would pay petitioners a reinsurance premium, which amounted to 98.3 percent of the gross monthly paid premiums, less commissions paid to the agent (Pet. App. A4).

Under the accident and health reinsurance contracts, Standard also reinsured with petitioners 100 percent of each accident and health policy and paid to them the reinsurance premium, which amounted to 98.3 percent of the "gross monthly earned premiums,"[1] less commissions paid and all other expenses (including taxes and claims) paid with respect to the accident and health insurance in the preceding month (Pet. App. A4-A5). However, the health and accident risks were reinsured "for a period of one month only," with a further provision for the reinsurance "automatically [to] renew itself from month to month until such time" as the policies reinsured expired or "until this treaty is cancelled as provided in Article IX" (Pet. App. A5-A6). It was further provided that petitioners would "have no right, title or interest in any unearned premiums or unearned premium reserves held by STANDARD"[2] (Pet. App. A5).

Relying on the fact that the reinsurance premiums were to be remitted on an "earned" basis, Standard reported the unearned premium reserves in its annual statement filed with the California Insurance Department. Petitioners did not report any portion of the unearned premium reserves in the annual statements filed with the Delaware insurance authorities (Pet. App. A7). In addi-

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[1]Under the reinsurance contract "gross monthly earned premiums" were defined as the pro rata part of the single premium corresponding to the duration of insurance coverage provided for in said policy during the preceding month (Pet. App. A5).

[2]It was stipulated (Pet. App. A7) that petitioners—

> reinsured credit accident and health insurance on a month-to-month basis, rather than for the full term of the policies, in order to avoid holding any unearned accident and health premium reserves and, therefore, reduce the amount of reserves which might be considered as non-qualifying reserves for the purpose of determining whether they were entitled to be taxed as life insurance companies under the reserve-ratio formula in § 801(a) of the Code.

tion, Standard would invest amounts roughly equivalent to the balance of the unearned accident and health premiums reserve in obligations of Economy Finance Corporation (one of the petitioners) and remitted the interest earned on these obligations to the agent, Schloss Insurance Agency (under common control with petitioners) (Pet. App. A2-A3, A7).

On their tax returns for 1959 and 1961, petitioners claimed that they qualified as life insurance companies under Section 801(a) of the Code because none of the accident and health reserves on the policies reinsured with them by Standard should be included in determining whether more than 50 percent of their total reserves were life insurance reserves. On audit, the Commissioner determined that the accident and health reserves on the policies reinsured with petitioners should be included in their total reserves. Accordingly, the Commissioner recomputed petitioners' tax liability on the basis that they were not life insurance companies and determined deficiencies (Pet. App. A2, A8-A9).

In these refund suits brought by petitioners, the district court held that because the reinsurance agreement was prompted by nontax business reasons, Standard and not petitioners was the proper party to establish and report the reserves on the reinsured accident and health business so that petitioners qualified as life insurance companies under the 50 percent rule of Section 801(a) (Pet. App. A8-A9, A50-A51). The court of appeals reversed, concluding that because the reinsurance contract with respect to the accident and health insurance did not spread the risk, the accident and health reserve should be attributed to petitioners. As a result, more than 50 percent of petitioners' reserves were attributable to non-life insurance so that they could not qualify as life insurance companies under Section 801(a) (Pet. App. A9, A19-A23).

ARGUMENT

1. Section 801(a) of the Code provides that in order for an insurance company to qualify for the special tax treatment accorded life insurance companies, its life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, health or accident policies not included in life insurance reserves must comprise more than 50 percent of its total reserves. As the Court of Claims explained in *Alinco Life Insurance Co.* v. *United States*, 373 F.2d 336, 346-347, this statutory test was intended to limit the favored tax status to companies conducting predominantly life insurance business as measured by their reserves. See also *National Protective Ins. Co.* v. *Commissioner*, 128 F.2d 948, 950 n. 3 (C.A. 8), certiorari denied, 317 U.S. 655.

Here, Standard agreed to pay petitioners a reinsurance premium equal to 98.3 percent of the gross monthly earned premiums less commissions and other expenses, including claims expenses (Pet. App. A4-A5, A43). Standard's interest was only in the commissions it received, which were not affected by the claims experience. Accordingly, it had no insurance risk (Pet. App. A19). Under the agreement, the premium payments retained by petitioners decreased as loss experience increased.

Hence, the court of appeals found that under the reinsurance agreement, petitioners had the ultimate risk of loss on the non-life accident and health insurance. It correctly concluded that for purposes of the statutory 50 percent test, the unearned premium reserves on this non-life business should be attributed to petitioners with the result that they did not qualify as life insurance companies under the statutory definition (Pet. App. A19, A22-A23).

Petitioners concede (Pet. 15) that the decision below is not in conflict with that of any other court of appeals.[3] They nevertheless argue (Pet. 11-12) that since there was a valid business reason for the reinsurance agreement, the court of appeals erred in ignoring it for tax purposes. However, whether or not there were business reasons (other than tax advantages) is irrelevant to the purpose of the 50 percent test of Section 801(a). As the court of appeals observed (Pet. App. A9):

> * * * accepting the legitimacy of that [business] purpose does not end the inquiry. The issue raised by the government is not whether taxpayers should actually have established H & A [health and accident] reserves but how such reserves should be considered for the limited purpose of determining taxpayers' qualifying ratio. This is not a question of form over substance but rather one of the proper characterization of the substance.

Thus, if the integrity of the 50 percent test of Section 801(a) is to be preserved, the fact that Standard recorded on its books the non-life reserves of the policies reinsured with petitioners is irrelevant. Cf. *Gregory* v. *Helvering*, 293 U.S. 465. For purposes of the statute, reserves should be attributed to the insurance company which in fact underwrites the risks of the policies, here petitioners. *Superior Life Insurance Co.* v. *United States*, 462 F.2d 945 (C.A. 4).

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[3]Despite the absence of any present conflict, the issue in this case continues to be litigated. On February 3, 1975, the Court of Claims, sitting *en banc*, heard argument on the inconsistent opinions of two of its Trial Judges on this issue. Compare *Penn Security Life Insurance Co.* v. *United States*, No. 109-68, decided March 2, 1973, with *Consumer Life Insurance Co.* v. *United States*, No. 463-70, decided December 13, 1974. Moreover, the issue is presently pending in the Fifth Circuit on the government's appeal in *First Railroad & Banking Co. of Georgia* v. *United States*, No. 73-3184.

At all events, to the extent that the tax motivation may be relevant, petitioners stipulated that the reason why the month-to-month basis of reinsuring credit accident and health insurance was chosen, rather than the full term of the policies, was (Pet. App. A7)—

> to avoid holding any unearned accident and health premium reserves and, therefore, reduce the amount of reserves which might be considered as non-qualifying reserves for the purpose of determining whether * * * [petitioners] were entitled to be taxed as life insurance companies under the reserve-ratio formula in § 801(a) of the Code.

Petitioners have therefore acknowledged that tax motivation played a role in the formulation of the arrangements in question.

2. Petitioners further contend (Pet. 14) that "the Seventh Circuit has forced a tax result inconsistent with insurance regulatory accounting" (Pet. 14).[4] But Standard was not "required" by any state regulation to carry these reserves and it does not appear that petitioners were precluded from carrying them by any state. Indeed, if petitioners had actually maintained the health and accident reserves in conformity with their assumption of the risk, Standard would not have been required to duplicate them. See National Association of Insurance Commissioners, *Examiner's Handbook* (Reinsurance Subcommittee Reports of 1961 NAIC Proceedings, Vol. 1, pp. 147-177),

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[4]There is no basis for petitioners' contention (Pet. 12-13) that the decision below jeopardizes the status of companies writing term insurance. Reserves are the traditional measure of insurance risks, whether those risks are assumed in a term or an ordinary policy. All this case holds (Pet. App. A7) is that for purposes of determining to which company the reserve should be attributed under Section 801(a), the reserves must be attributed to the company which bears the risk (Pet. App. A19, A22, A23, A28). See *Alinco Life Insurance Co.* v. *United States*, *supra*, where the Court of Claims held that short-term life insurance reserves are a life insurance reserve for tax purposes.

Part B, p. B14). Thus, the decision below is in no way inconsistent with state insurance regulatory requirements.

3. Finally, petitioners urge (Pet. 16) that this decision requiring that the gross unearned premium reserve—rather than the "net"—be included in the total reserves, is in conflict with *Alinco Life Insurance Co.* v. *United States, supra*; *Great Commonwealth Life Insurance Co.* v. *United States*, 491 F.2d 109 (C.A. 5); and Treasury Regulations on Income Tax, Section 1.801-3(e). *Alinco* and *Great Commonwealth*, however, involved life insurance reserves which are not computed on the same gross unearned premium basis as health and accident reserves. See Mehr & Cammack, *Principles of Insurance*, pp. 683-691 (1972 ed.). Hence, those cases are not pertinent authority with respect to the definition of unearned premium reserves on accident and health insurance, which are defined for tax purposes as the gross unearned premium reserve. See *Superior Life Insurance Co.* v. *United States, supra*, 462 F.2d at 951.

Petitioners' argument concerning Treasury Regulations, Section 1.801-3(e), was specifically rejected in *Superior Life Insurance Co.* v. *United States, supra*, a case involving the same type of credit accident and health insurance. There, the Fourth Circuit held that the gross unearned premium rather than the net unearned premium was included in the total reserves and that this was not inconsistent with Treasury Regulations, Section 1.801-3(e), which defines unearned premiums as "those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance." In so holding, the court stated that "both the morbidity portion and the loading portion are, we think, 'costs' of insuring" (462 F.2d at 951). The inclusion of the gross accident and health reserves in petitioners' reserves is therefore in complete conformity with the Regulation.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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